CHAPTER 6

CORPORATE TAX RATES

The Treasury Department proposals would define the corporate tax base more accurately and comprehensively. The corporate income tax rate could thus be reduced to 33 percent. Moreover, the corporate minimum tax and the personal holding company tax could be repealed.

REDUCE CORPORATE INCOME TAX RATES

General Explanation

Chapter 6.01

Current Law

In general, a tax is imposed on the taxable income of corporations at a maximum rate of 46 percent for all such income in excess of $100,000. For corporate income under $100,000, tax generally is imposed under the following schedule:

(1) 15 percent of so much of the taxable income as does not exceed $25,000;

(2) 18 percent of so much of the taxable income as exceeds $25,000 but does not exceed $50,000;

(3) 30 percent of so much of the taxable income as exceeds $50,000 but does not exceed $75,000; and

(4) 40 percent of so much of the taxable income as exceeds $75,000 but does not exceed $100,000.

The graduated rates are phased out for corporations with taxable income over $1,000,000, so that corporations with taxable income of $1,405,000 or more pay, in effect, a flat tax at the 46 percent rate.

Reasons for Change

The current corporate income tax structure overtaxes some corporations and undertaxes others. Although corporations generally are subject to a uniform rate structure, the base of income subject to tax differs depending on the extent to which corporations are able to generate preferred sources of income or deductions. For corporations with overstated deductions or losses, or deferred or exempt income, the effective rate of tax may be far below the prescribed statutory rate. By broadening the base of corporate income, corporate tax rates can be reduced and made applicable on a more nearly uniform basis.

In addition, the current progressive rate structure for corporate income serves no affirmative purpose and encourages the use of corporations to gain the advantage of low marginal tax rates. The progressive rate structure for individuals is premised on the ability-to-pay concept, which in turn reflects an assumption that additional amounts of income are increasingly available for discretionary, nonessential consumption. These concepts have no relevance to corporate income, all of which is either distributed or used to produce additional income. Moreover, under current law a small corporation can escape high marginal tax rates on corporate income by electing pass-through treatment as an S corporation.

Finally, the Treasury Department proposals include partial dividend relief, which would mitigate the impact of corporate tax rates on all corporations. See Chapter 7.01.

The current low rates of tax for certain amounts of corporate income permit the use of corporations as tax shelters for individuals. Thus, an individual may attempt to accumulate investment income within a corporation in order to defer tax on the income at the individual's rate. Where the corporate rate is significantly below the individual's marginal rate, the deferral advantage can more than offset the extra burden of the corporate tax. Current law attempts to limit this use of the corporate form through a surtax on the undistributed income of "personal holding companies." The personal holding company rules are complex and not uniformly effective.

The progressive tax structure for corporate income also encourages multiple corporations in order to maximize income taxed at the lowest rates. The current rules limiting this use of the corporate form are again complex and not consistently effective.

Proposal

The present corporate rate structure would be replaced by a flat tax rate for corporations of 33 percent.

Effective Date

The reduction in the maximum corporate tax rate to 33 percent would be effective for taxable years beginning on or after July 1, 1986.

For corporations formed after the date legislation is introduced, the repeal of the graduated corporate rate structure would be effective for taxable years beginning on or after July 1, 1986. For corporations formed on or before such date, the repeal of the graduated rate structure would be phased in. For these corporations, the one-half of the rate increase necessary to raise the lower bracket rates to 33 percent would be implemented for taxable years beginning on or after July 1, 1986, but before January 1, 1987. For taxable years beginning on or after January 1, 1987, all corporations would be subject to the flat rate.

Analysis

Elimination of the graduated corporate rate structure would generally make unnecessary the current provisions concerning domestic personal holding companies and multiple surtax exemptions. Accordingly, those provisions would be repealed to the extent appropriate for taxable years beginning on or after January 1, 1987, when repeal of the graduated corporate rate structure is complete.

REPEAL CORPORATE MINIMUM TAX

General Explanation

Chapter 6.02

Current Law

Taxpayers whose taxable incomes are substantially reduced by specified "items of tax preference" are subject to "minimum taxes" which may increase their overall tax liabilities. Corporations with substantial tax preferences are subject to the add-on corporate minimum tax.

In general, the corporate minimum tax (CMT) is equal to 15 percent of the amount by which the taxpayer's items of tax preference exceed the greater of (a) $10,000 or (b) the regular corporate income tax for the taxable year (without regard to the accumulated earnings tax or personal holding company tax, if any, and reduced by most allowable tax credits).

Items of tax preference, in general (some are applicable only to personal holding companies), include:

(a) the excess of accelerated over straight-line depreciation for real property and leased personal property (other than recovery property);

(b) in the case of recovery property other than leased 18-year real property, the excess of ACRS deductions over depreciation deductions that would have been allowed had the property been depreciated using under the straight-line method over prescribed (extended) recovery periods;

(c) the tax preference for long-term capital gains;

(d) the excess of amortization deductions for pollution control facilities over the depreciation deductions which would otherwise have been allowable in the absence of special amortization;

(e) in the case of mining exploration and development costs and circulation expenditures, the excess of the amount allowable as a deduction over the amount which would have been allowable had such costs or expenditures been amortized over a ten-year period;

(f) in the case of intangible drilling and development costs of oil, gas, and geothermal properties, the amount by which (i) the excess of the amount allowable as a deduction over the amount which would have been allowable had such costs been amortized over a ten-year period, exceeds (ii) the taxpayer's net income from oil, gas, and geothermal properties;

(g) the excess of a financial institution's deduction for bad debt reserves over the deduction that would have been allowable had the institution maintained its reserves on the basis of actual *experience; and*

(h) the excess of depletion deductions over the basis of the depletable property.

Reasons For Change

The minimum taxes for both individuals and corporations were originally enacted as part of the Tax Reform Act of 1969 to ensure that "all taxpayers are required to pay significant amounts of tax on their economic income." The measures (originally a single minimum tax for all taxpayers) were considered necessary because, as concluded by Congress, "many individuals and corporations did not pay tax on a substantial part of their economic income as a result of the receipt of various kinds of tax-favored income or special deductions."

The judgment that a minimum tax is necessary reflects an ambivalence about the desirability and effectiveness of the tax preferences subject to the tax. For example, percentage depletion and accelerated methods of depreciation have traditionally been allowed in part to subsidize the cost of productive depreciable assets and mineral production activities. However, Congress disapproved the consequence that taxpayers receiving the bulk of their income from nonpreferred activities were taxed at relatively higher rates than taxpayers engaged in activities, such as real estate or natural resource production, that benefitted from tax preferences.

The ambivalence in current law toward tax preferences reflects significant doubt about their fairness, efficiency, costs in lost revenue, and consequent effect on marginal tax rates. In general, the Treasury Department proposals accept these doubts as well founded and seek to redesign the income tax base to more closely approximate economic income. If the proposals were fully implemented, the corporate minimum tax would be unnecessary.

To the extent that (1) existing tax preferences (which generally cause a taxpayer's taxable income to be less than economic income) are phased out over an extended period, or (2) taxpayers currently holding tax-favored assets are permitted to retain benefits not available for after-acquired assets, immediate repeal of the corporate minimum taxes would be inappropriate.

Proposal

The corporate minimum tax would be repealed.

Effective Date

The repeal would be effective for taxable years beginning on or after January 1, 1990.

Analysis

Once the corporate tax base is redefined under the proposals to approximate economic income, the need for the corporate minimum tax is eliminated. A by-product of repeal is a slight reduction in the tax-filing burden for the approximately ten thousand corporations who currently pay some minimum tax as well as the computations for most other large corporations which are necessary to determine that they do not, in fact, have any minimum tax liability.

CHAPTER 7

TAXATION OF BUSINESS ORGANIZATIONS

Equity investment in the corporate sector is discouraged by the relatively high effective rate of taxation imposed on the return from such investment. The only relief provided by current law from the relatively high rate, caused by the double taxation of corporate dividends, is the exclusion available to individual shareholders for the first $100 of dividend income received. The Treasury Department proposes to repeal this exclusion and to institute a corporate-level deduction for 50 percent of previously taxed corporate earnings paid out as dividends.

Investors are able to form limited partnerships that closely resemble corporations, but are not so treated for tax purposes. The Treasury Department proposal would classify certain large limited partnerships as corporations subject to the corporate income tax.

REDUCE DOUBLE TAXATION OF CORPORATE EARNINGS DISTRIBUTED TO SHAREHOLDERS

General Explanation

Chapter 7.01

Current Law

In general, corporations are treated as taxpaying entities separate from their shareholders for Federal income tax purposes. Thus, a corporation separately reports and is directly taxable on its income. Correspondingly, the income of a corporation is not taxable to its shareholders until actually distributed to them. An exception to these rules is provided on an elective basis under Subchapter S of the Code. Taxable income of an S corporation is allocated among and taxed directly to its shareholders. This pass-through tax regime is limited to corporations meeting certain requirements, including that the corporation have only one class of stock and 35 or fewer shareholders.

Dividends paid by corporations other than S corporations are taxed to individual shareholders as ordinary income (except for a $100 per year exclusion). Corporate shareholders generally are taxed on only 15 percent of dividends received from other corporations, and are not subject to tax on dividends received from certain affiliated domestic corporations, such as controlled subsidiaries. Corporations are not entitled to a deduction for dividends paid to shareholders. Consequently, corporate taxable income paid as dividends to individual shareholders generally bears two taxes, the corporate income tax and the individual income tax. Corporations are permitted, however, to deduct interest paid on corporate indebtedness, even if paid to creditors who also are shareholders.

Corporate distributions to shareholders generally are taxable "dividends" to the extent of (i) the corporation's earnings and profits in the year of distribution plus (ii) earnings and profits accumulated in prior years. In concept, a corporation's earnings and profits represent its ability to make distributions to shareholders without impairing invested capital. Thus, earnings and profits, in general, measure economic income of the corporation available for distribution to shareholders. Distributions to shareholders in excess of current and accumulated earnings and profits first reduce the shareholders' basis in their stock, and, to the extent of the excess, are taxed as amounts received in exchange for the stock.

If a corporation redeems its stock from a shareholder, the distribution from the corporation generally is treated as a payment in exchange for the stock and any resulting gain to the shareholder is taxed as a capital gain. Similarly, amounts received by a shareholder in a distribution in complete liquidation of the corporation are treated as payments in exchange for the stock. Such sale or exchange treatment also applies to distributions in partial liquidation to noncorporate shareholders.

Reasons for Change

Distortions in Economic Behavior. The disparate tax treatment of debt and equity in the corporate sector distorts a variety of decisions concerning a corporation's capitalization as well as its policies with regard to investment or distribution of earnings. Because interest payments are deductible by a corporation and dividend distributions are not, corporate earnings distributed to shareholders are subject to both corporate and shareholder income taxes, whereas corporate earnings distributed as interest are taxable only to the creditor. The effective double taxation of dividends encourages corporations to finance their operations with debt rather than equity. This reliance on debt capital increases the vulnerability of corporations both to the risks of bankruptcy and to cyclical changes in the economy.

The different treatment of interest and dividends under current law also places great significance on rules for distinguishing debt from equity. Historically, the distinction for tax purposes has rested on a series of general factors which have been given different weight depending on the circumstances of the taxpayer and on the particular court making the determination. This approach has increasingly generated uncertainty, especially as more sophisticated financial instruments have merged the traditional characteristics of debt and equity. Although attempts have been made to formulate and codify more or less mechanical tests for distinguishing debt from equity, no consensus exists concerning the proper criteria for such tests. Considerable uncertainty thus remains under current law as to whether instruments will be treated as debt or equity for tax purposes.

The double taxation of earnings distributed as dividends to shareholders also affects corporate distribution policy in ways that detract from the efficiency of the economy. Corporations with shareholders in relatively high tax brackets are encouraged to retain earnings, in order to defer shareholder level income tax. Corporations with shareholders who are tax exempt or in relatively low tax brackets are encouraged to distribute earnings, so that the shareholders may invest those earnings without bearing future corporate-level income tax. These incentives for or against distribution of earnings interfere with ordinary market incentives to place funds in the hands of the most efficient users.

The double taxation of corporate earnings distributed to shareholders also increases the cost of capital for corporations and discourages capital-intensive means of production in the corporate sector. Similarly, double taxation discriminates against goods and services that are more readily produced or provided by the corporate sector as well as activities customarily engaged in by corporations. Investors are thus discouraged from using the corporate form, even in circumstances where nontax considerations make it desirable. The elective provisions of Subchapter S provide only limited relief from these effects.

Proposal

Deduction for Dividends Paid. The double taxation of corporate earnings distributed as dividends would be partially relieved under the proposal by allowing domestic corporations, other than those subject to special tax regimes (e.g., regulated investment companies), a deduction equal to 50 percent of dividends paid to their shareholders ("dividends paid deduction"). The amount of dividends subject to the dividends paid deduction would be limited, however, to ensure that the deduction is allowed only with respect to dividends attributable to corporate earnings that have borne the regular corporate income tax. Thus, relief from double taxation of dividends would be provided only when the income with respect to which the dividends are paid is actually taxed at the corporate level. The dividends paid deduction, therefore, would not be available with respect to corporate distributions from so-called tax preference income.

The limitation on the source of deductible dividends would be provided by requiring every corporation to maintain a Qualified Dividend Account. The amount of dividends with respect to which a deduction could be claimed in any taxable year would be limited to the Qualified Dividend Account balance as of the end of the year during which the dividends were paid. Dividends paid during a taxable year in excess of the Qualified Dividend Account balance as of the end of the year would not be eligible for the dividends paid deduction. Moreover, these excess dividends could not be carried forward and deducted with respect to amounts added to the Qualified Dividend Account in subsequent years.

The Qualified Dividend Account would consist of all earnings that have borne the regular corporate tax, less any deductible dividends paid by the corporation. Thus, the Qualified Dividend Account would be increased each year by the amount of the corporation's taxable income (computed without regard to the dividends paid deduction). The amount of taxable income added to the Qualified Dividend Account each year, however, would be reduced by the amount of any taxable income that, because of any allowable credit, did not actually bear the corporate tax. For this purpose, foreign tax credits would be treated the same as any other credit. The Qualified Dividend Account would thus include none of the corporation's tax preference income.

The Qualified Dividend Account would be decreased each year by the amount of any dividends paid by the corporation with respect to which a dividends paid deduction was allowable. Dividends paid during a year in excess of the Qualified Dividend Account balance as of the end of the year, however, would have no effect. Thus, the Qualified Dividend Account balance would never be reduced below zero. As described below, the Qualified Dividend Account also would be reduced to reflect distributions in redemption or in partial or complete liquidation.

The Qualified Dividend Account balance would be indexed to account for inflation. Rules would be provided to govern the transferability of the Qualified Dividend Account in mergers and acquisitions.

The dividends paid deduction allowed to corporations would be treated similarly to other business deductions. For example, the deduction would enter into the determination of a corporation's net operating loss and thus could be carried back and forward. Similarly, the dividends paid deduction would be taken into account for purposes of computing a corporation's estimated tax liability.

Distributions in Redemption, Partial Liquidation, and Complete Liquidation, and Other Corporate Distributions. A corporation would be entitled to the dividends paid deduction with respect to distributions in redemption of stock, including distributions in partial or complete liquidation. Consequently, the Qualified Dividend Account would be reduced by the amount of the redemption or liquidation proceeds with respect to which the corporation was entitled to a deduction.

In the case of a distribution in complete liquidation, the liquidating corporation would be entitled to a dividends paid deduction as though it had distributed dividends in an amount equal to the Qualified Dividend Account balance at the time of the liquidation (but not in excess of the amount of the liquidation proceeds).

In the case of a distribution in redemption or partial liquidation, the corporation would be entitled to the dividends paid deduction as though it had distributed dividends equal to a specified portion of the corporation's Qualified Dividend Account. The portion of the Qualified Dividend Account treated as distributed would be computed using a method similar to the one used under current law to compute the portion of a distribution in redemption that is properly chargeable to earnings and profits. Accordingly, the portion of the Qualified Dividend Account treated as distributed in redemption or partial liquidation generally would be proportionate to the amount of the corporation's outstanding stock that is redeemed (but not in excess of the amount of proceeds distributed to shareholders).

Under current law, certain transactions not formally denominated as dividends by distributing corporations are treated as dividends for tax purposes. These transactions include certain redemptions (section 302(d)), certain stock purchases by corporations related to the issuer (sections 302(d) and 304), certain stock dividends (sections 305(b) and (c)), certain sales and other distributions of preferred stock (section 306), and certain "boot" received in otherwise tax-free reorganizations or divisions (sections 356(a)(2), 356(b), and 356(e)). Corporations making distributions to shareholders in such transactions would be permitted to treat the distributions as dividends subject to the dividends paid deduction, provided that the corporations treated the distributions as dividends for information reporting purposes. In the event a distributing corporation did not treat such a distribution as a dividend for information reporting purposes and therefore did not claim a dividends paid deduction, the Internal Revenue Service would have the authority to allow the deduction if the transaction were subsequently characterized as a dividend and the corporation and shareholder treated the transaction consistently.

Intercorporate Investment. The treatment under the proposal of dividends paid to corporate shareholders would ensure that the relief from double taxation of corporate earnings would not be available until the earnings were distributed outside the corporate sector. In addition, current law applicable to the receipt of dividends by corporate shareholders would be changed to eliminate the small portion of certain dividends (generally 15 percent) that is subject to more than two levels of tax.

Under the proposal, a corporation paying dividends would compute its dividends paid deduction without regard to whether the recipient shareholders were corporations. A payor corporation, however, would be required to report to its corporate shareholders the portion of dividends paid to such shareholders that was allowable as a deduction to the payor corporation.

Corporate shareholders would be required to include in their taxable income the portion of dividends for which the payor corporation received the dividends paid deduction. Accordingly, the dividends received deduction allowable under current law would be reduced to 50 percent of deductible dividends received. A 100 percent dividends received deduction would be allowed, however, with respect to dividends that were not deductible by the payor corporation. Thus, a corporate shareholder would be entitled to a 100 percent dividends received deduction with respect to dividends paid in excess of the payor corporation's Qualified Dividend Account balance.

Although a corporate shareholder generally would be taxed on only one-half of the dividends it receives, the full amount of such dividends would increase the corporate shareholder's own Qualified Dividend Account balance. This full increase would ensure that the relief from double taxation is not diminished simply because of the existence of multiple layers of corporate shareholders.

A foreign corporation would not be eligible for the dividends paid deduction. However, the dividends received deduction allowable under current law with respect to dividends received by a domestic corporate shareholder from a foreign corporation's earnings subject to United States corporate tax would be increased to 100 percent of such dividends received.

The current law rules that fully tax certain dividends received by corporate shareholders would not be changed by the proposal. If, therefore, a corporate shareholder would not be entitled to a dedution under current law with respect to the receipt of a particular dividend, the dividend would not be subject to the special intercorporate rules of the proposal. Accordingly, the payor corporation would be eligible for a deduction with respect to the dividend paid, the full amount of the dividend would be taken into account in computing the corporate shareholder's taxable income, no dividends received deduction would be allowed to the shareholder, and no special rules would be used to compute the shareholder's Qualified Dividend Account.

The application of these intercorporate rules may be illustrated by assuming that a wholly owned subsidiary corporation with a Qualified Dividend Account balance of $1,500 paid a $500 dividend to its parent corporation. The entire $500 dividend would be eligible for deduction by the subsidiary, which would thus be entitled to a dividends paid deduction of $250 and would be required to reduce its Qualified Dividend Account by the amount of the dividend to $1,000. The subsidiary also would be required to inform its parent that it was allowed a $250 dividends paid deduction with respect to the $500 dividend. The parent would thus include $500 in its gross income and would be entitled to a $250 dividends received deduction. The parent would thus be taxed on one-half of the dividends received from its subsidiary. The parent's Qualified Dividend Account, however, would be increased by $500 with respect to the dividend received.

In summary, the subsidiary corporation would be subject to tax on $250 with respect to the earnings from which the dividend is treated as having been paid. In addition, if the parent corporation made no distributions to its shareholders, it would be subject to tax on $250 of income with respect to the intercorporate dividend. Under current law, an equivalent $500 of income would be taxed to the two corporations, although the entire amount would be taxed to the subsidiary. The proposal thus imposes the full measure of the corporate tax, but no more than that, in the case of intercorporate dividends that are not distributed outside the corporate sector.

If, however, the parent paid $500 in dividends to its shareholders, all of whom were individuals, it would be entitled to a $250 dividends paid deduction. Accordingly, the parent would not be subject to any tax with respect to the earnings attributable to the intercorporate dividend and, while the individual shareholders have been taxed on the distribution, one-half of the double taxation would thus be relieved. The parent's Qualified Dividend Account would be reduced by $500 with respect to the dividends paid to its shareholders.

Treatment of foreign shareholders. A compensatory withholding tax would be imposed on dividends paid to foreign shareholders who are not entitled to the benefits of a bilateral tax treaty. The compensatory withholding tax rate would equal the corporate income tax rate times the percentage of dividends that is eligible for the dividends paid deduction. Thus, the compensatory withholding tax rate would be 16.5 percent (50 percent of the corporate income tax rate). Dividends that were not eligible for the dividends paid deduction, because they exceeded the balance in the corporation's Qualified Dividend Account, would not bear the compensatory withholding tax. The compensatory withholding tax would be imposed in addition to the basic 30 percent withholding tax on dividends paid to foreign shareholders who are not entitled to treaty benefits. In addition, subject to the reservations expressed in the Analysis section of this chapter, the compensatory withholding tax would not be imposed on dividends paid to foreign shareholders entitiled to treaty benefits.

Earnings and Profits. The measurement of the extent to which corporate distributions to shareholders constitute dividends would continue to be based on the payor corporation's current and accumulated earnings and profits. Earnings and profits would continue to be a measure of the economic income of the corporation. The precise definition of earnings and profits, however, would be modified as necessary to reflect other proposed changes. In addition, earnings and profits accumulated after the effective date would be indexed to account for inflation.

Effective Date

The proposal generally would be effective on January 1, 1987. The relief from double taxation would be phased in over six years, with a 25 percent deduction allowed with respect to dividends paid in 1987 and a five percentage point increase in the deduction for each of the next five calendar years. Accordingly, the 50 percent dividends paid deduction would apply in 1992 and later years.

Similarly, the reduction in the current law dividends received deduction for corporate shareholders would be phased in over six years, with a 75 percent deduction allowed with respect to deductible dividends paid in 1987 and a five percentage point decrease in the deduction for each of the next five calendar years. A 50 percent dividends received deduction with respect to deductible dividends would thus begin to apply in 1992. The compensatory withholding tax imposed on foreign shareholders not entitled to treaty benefits also would be phased in from 8.25 percent (25 percent of the corporate tax rate) in 1987 to 16.5 percent (50 percent of the corporate tax rate) in 1992 and later years.

The Qualified Dividend Account would include taxable income only for taxable years beginning after December 31, 1986. In addition, dividends paid after December 31, 1986, in taxable years beginning before January 1, 1987, would be treated for purposes of the dividends paid deduction as having been paid during the first taxable year beginning after December 31, 1986. Finally, current law would continue to apply to dividends paid with respect to preferred stock issued prior to January 1, 1987.

Analysis

In General. The proposal would reduce the existing incentive for corporations to raise capital by issuing debt and would make equity securities more competitive with debt. Because dividend relief also would reduce the incentive to retain earnings, corporations would be likely to pay greater dividends and to seek new capital, both equity and debt, in the financial markets. Corporations would thus be subject to greater discipline in deciding whether to retain or how to invest their earnings. The increased level of corporate distributions would expand the pool of capital available to new firms. This should, in turn, enhance productivity and efficiency across the economy.

Effect of Reduction in Tax Rates. Under current law, corporate earnings paid out as dividends to an individual shareholder in the highest tax bracket may be subject to an overall tax rate of 73 percent (46 percent on the earnings at the corporate level and 50 percent on the after-tax amount of the dividend at the individual shareholder level). Because interest payments are deductible by the corporation, earnings paid out as interest to an individual creditor are taxed at a maximum rate of only 50 percent. Consequently, earnings distributed as dividends are relatively overtaxed by 23 percentage points. Without other changes, lowering the maximum corporate rate to 33 percent and the maximum individual rate to 35 percent would reduce the relative overtaxation only by a small amount, from 23 points to approximately 21 points. Therefore, the reduction in tax rates proposed by the Treasury Department would not reduce the need for relief from the double taxation of dividends. Under the proposal for partial dividend relief, the maximum overall tax rate on corporate earnings distributed as dividends to individual shareholders would be approximately 45 percent. This rate exceeds the maximum rate on corporate earnings paid out as interest by approximately ten percentage points.

Effects on Specific Industries. Industries and firms that distribute a large fraction of their earnings as dividends are more seriously affected by the current double taxation of dividends. The proposal, therefore, may increase the flow of resources to these industries. Prime examples of industries that may derive relatively greater benefit from the dividends paid deduction are the communication industry and public utilities, such as electric, natural gas, and sanitary utilities. These industries each distributed approximately 100 percent of their after-tax profits as dividends during the period from 1980 through 1983.

Foreign Experience. The United Kingdom, France, West Germany, Japan, Canada, and other countries have adopted tax regimes that partially relieve the double taxation of dividends. Many of these countries enacted relief for policy reasons that do not apply equally to the United States, and have chosen different systems than the one proposed by the Treasury Department. As shown in Appendix C of Volume I of this Report, the extent of dividend relief provided by these countries ranges from 38 percent to 100 percent. The Treasury

Department proposal, for a 50 percent dividends paid deduction, would provide more relief than Japan (at 38 percent) or Canada (at 40 percent), the same as France, and less than Germany (at 100 percent) or the United Kingdom (at 80 percent after 1986). In sum, the proposal would bring the taxation of corporate dividends in the United States more in line with that imposed by some of its major trading partners.

Treatment of Foreign Shareholders. Most of the countries that have adopted some form of relief from the classical system of double taxation of corporate earnings distributed to shareholders have denied part or all of the benefits of that relief to foreign shareholders, although some countries have granted dividend relief to foreign shareholders through bilateral tax treaties. The United States has been only partially successful in obtaining the benefits of other countries' dividend relief provisions for its citizens and residents.

The most common method of dividend relief that has been adopted by these countries is the so-called "imputation" system. Under such a system, shareholders include in income and are entitled to claim a credit for a portion of corporate taxes paid on distributed earnings. The benefits of such a system usually are denied to foreign shareholders simply by allowing only domestic shareholders to obtain the credit for taxes paid by the corporation.

In contrast to the imputation system adopted in many countries, the proposal would allow domestic corporations a deduction equal to one-half of certain dividends paid to their shareholders. The benefits of this dividend deduction system could be denied to foreign shareholders by imposing a compensatory withholding tax on deductible dividends paid to foreign shareholders. The amount of the compensatory withholding tax would exactly offset the deduction allowable to the payor corporation.

Virtually all United States bilateral tax treaties, however, establish a maximum rate at which withholding taxes may be assessed on dividends. Those treaty provisions would be directly violated if the benefits of the dividends paid deduction were denied to foreign shareholders by imposing a compensatory withholding tax on dividends paid to residents of treaty countries.

Countries using the imputation system have avoided this treaty difficulty, while denying the benefits of dividend relief to foreign shareholders, because, as a purely formalistic matter, no increased withholding tax is imposed when the ability to obtain the credit is limited to domestic shareholders. Accordingly, the denial of the benefit to foreign shareholders technically does not result in a direct treaty violation.

As a matter of economic substance, there is no difference between denying foreign shareholders a credit for corporate taxes paid under an imputation system of dividend relief and imposing a compensatory withholding tax on distributions to foreign shareholders under a dividends paid deduction system. Because the two schemes are economically equivalent, it would be unwarranted to adopt an imputation system, rather than a dividend deduction system, merely to avoid technical treaty violations. Moreover, in the context of the United States economy and tax system, an imputation approach to dividend relief would be extremely cumbersome. A dividend deduction system, therefore, has been proposed.

Because the United States benefits significantly from its bilateral income tax treaties and takes seriously its obligations under those treaties, it is reluctant unilaterally to violate the treaties. Accordingly, subject to the concerns expressed below, the proposed compensatory withholding tax initially would not be imposed with respect to dividends paid to shareholders resident in treaty countries and the benefits of dividend relief thus would be extended unilaterally to such shareholders.

This unilateral extension of dividend relief to certain foreign shareholders is troubling in two respects. The first concern involves "treaty shopping," which is the use, through conduit corporations, of tax treaties by residents of non-treaty countries. Only a limited number of treaties presently lend themselves to abuse in this way and negotiations aimed at resolving this problem with these countries are continuing. The incentives to engage in treaty shopping, however, may be increased under the proposal. Therefore, efforts to eliminate treaty shopping would be intensified. If it is not possible to resolve this problem in the very near future, then the United States should, at a minimum, refuse to allow the benefits of the dividends paid deduction to persons claiming benefits under treaties that lend themselves to treaty shopping.

Second, as already noted, countries with imputation systems generally have not unilaterally extended the benefits of dividend relief to United States residents, although several have extended some or all of the benefits through treaty negotiations. The United States would expect that countries that have not previously done so would extend the benefits of their dividend relief rules to United States residents. Treaty negotiations would thus be undertaken with that view. Unwillingness of treaty partners to negotiate meaningfully on this issue would cause a reevaluation of the decision unilaterally to extend benefits to foreign shareholders in treaty countries. The Treasury Department expects to work closely with United States treaty partners and Congress in assessing concerns and progress in these areas.

Transition Issue: Effect on Share Prices. The double taxation of corporate earnings distributed as dividends probably has resulted in corporate shares trading at lower prices than would have occured if all corporate income were taxed only once. Reducing or eliminating the second level of tax might initially cause share prices to rise. Most current owners of corporate shares acquired their shares at prices that reflected a discount for most or all of the expected double tax on corporate income. Consequently, reducing the double tax would reward many who did not bear the effect of current law on share prices, producing windfall profits for those shareholders. For this reason, any relief from the double taxation of corporate earnings distributed to shareholders should be phased in over time.

Scope of Proposal. Other than the proposal for partial relief from the double taxation of dividends, the Treasury Department proposals do not address the general principles of current law governing taxation of corporations and shareholders. Thus, in general, no proposals have been made regarding the taxation of corporate liquidations, reorganizations, or the carryover of corporate tax attributes, including net operating losses. The rules in these areas are frequently cited as in need of reform, and important work has been undertaken in a number of sectors to rationalize and simplify current law. The Treasury Department is interested in and supportive of efforts to reform current rules for the taxation of corporations and shareholders. No inference to the contrary should be drawn from the fact that these issues have not been addressed in the Treasury Department proposals.

REPEAL $100/$200 DIVIDEND INCOME EXCLUSION

General Explanation

Chapter 7.02

Current Law

Dividend income received by an individual generally is subject to Federal income taxation. There is, however, an exclusion from gross income for the first $100 of dividend income received by an individual from domestic corporations. In the case of a husband and wife filing a joint return, the first $200 of dividend income is excluded regardless of whether the dividend income is received by one or both spouses.

Reasons for Change

The $100 dividend exclusion narrows the base of income subject to tax without creating a proportionate incentive for investment in domestic corporations. The exclusion provides no marginal investment incentive for individuals with dividend income in excess of $100, and only a minor incentive for other individual taxpayers. In addition, the partial dividends-received exclusion contributes to complexity in the tax system by adding an extra line (and two entries) on the individual tax Form 1040 and two lines on the Form 1040A.

Proposal

The partial exclusion for dividends received by individuals would be repealed.

Effective Date

The provision would apply to taxable years beginning on or after January 1, 1986.

Analysis

Repeal of the dividend exclusion is not likely to have a significant effect on aggregate economic behavior. The great majority (76 percent) of taxpayers who receive dividends claim the full amount of the dividend exclusion. For these taxpayers, repeal of the exclusion would have no effect on marginal tax rates and thus should not affect investment decisions. Even for those taxpayers who do not receive sufficient dividends to claim the full amount of the exclusion, repeal should not have a significant impact. Although the current marginal rate of tax for such persons on additional dividends (up to the amount of the exclusion) is zero, the relatively small tax savings available from the exclusion (up to $50 for individuals and $100 for joint returns, assuming a maximum tax rate of 50 percent) is not a substantial investment incentive.

TAX LARGE LIMITED PARTNERSHIPS AS CORPORATIONS

General Explanation

Chapter 7.03

Current Law

In general, business organizations treated as corporations are separate taxable entities for Federal income tax purposes. Thus, a corporation separately determines and reports its income and is directly taxable on such income. A corporation's income is not taxable to its shareholders until actually distributed to them, and corporate losses do not pass through to shareholders, but must be absorbed, if at all, against corporate income.

In contrast to the tax treatment of corporations, business organizations treated as partnerships are not separate entities for tax purposes. Although a partnership determines and reports its income as though a separate entity, it has no direct liability for tax. Instead, each item of partnership income, gain, loss, deduction or credit flows through to its partners, who must report such items on their respective separate tax returns.

Under Treasury regulations, business organizations are treated as corporations or partnerships for tax purposes depending on the extent to which they possess the following characteristics found in a "pure" corporation: continuity of life; centralization of management; limited liability; and free transferability of interests. Business organizations not possessing a "preponderance" of corporate characteristics are treated as partnerships.

Current law also permits corporations which meet certain requirements to elect to be treated as S corporations for tax purposes. An S corporation is not subject to the corporate income tax. Instead, its income and losses flow through to its shareholders and are reported by them on their respective separate tax returns. Among the requirements for S corporation status is that the corporation have no more than 35 shareholders.

Reasons for Change

The existing rules for distinguishing partnerships and corporations are inadequate. They permit many organizations, not formally incorporated but having most of the practical attributes of corporations, to be treated as partnerships for tax purposes. These rules in turn have permitted investors in such a partnership to receive pass-through tax treatment with respect to the partnership's income and loss even though their economic relationship to the partnership and with other partners is in important respects indistinguishable from that of shareholders of a comparably sized corporation.

In large part, the pass-through characteristics of the partnership form have been exploited by investment tax shelters organized as limited partnerships. These tax shelter partnerships draw capital from a diverse and widely situated group of investors. Moreover, because of the legal characteristics of a limited partnership, the investor limited partners are not active in the day-to-day management of the enterprise, are protected from loss in excess of their investment, and frequently face minimal restrictions on transfer or assignment of their interests. In short, the limited partnership vehicle offers many of the investment and legal characteristics of a corporation, yet under current law is treated for tax purposes as a partnership.

The availability of pass-through tax treatment for limited partnerships, regardless of size, has encouraged a significant shift in investment capital from the corporate sector to the partnership sector. It is also inconsistent with the tax law's general limitations on losses from wholly passive investments. These limitations properly extend to investments in active businesses where the number of investors involved or the legal relations between investors and the business indicate the absence of direct investor management, control, or responsibility.

A limited partnership with a large number of limited partners also presents serious audit and administrative problems for the Internal Revenue Service. An adjustment in income or loss of the partnership generates a corresponding adjustment for each of the partners. This requires a large number of returns to be held open and may necessitate multiple collection actions. Where the adjustment occurs years after the fact, transfers of partnership interests or changes in the circumstances of individual partners may have occurred so as to make collection impossible.

Proposal

A limited partnership would be treated as a corporation for tax purposes if at any time during the taxable year the partnership has more than 35 limited partners. If an S corporation were a limited partner in a partnership, each shareholder in the S corporation would be treated as a separate limited partner for purposes of the 35 limited partner rule. If a grantor trust were a limited partner, each owner of the trust would be counted as a limited partner. If a partnership were a limited partner in a second partnership, each partner in the first partnership would be treated as a limited partner in the second partnership. In addition, as under the current law S corporation rules, a husband and wife would be counted as one limited partner.

In general, the addition of the 36th limited partner to an existing limited partnership would be treated as a termination of the limited partnership and contribution of the partnership assets to a newly formed corporation.

Effective Date

In general, the proposal would be effective January 1, 1986. For limited partnerships organized before the proposal is introduced as legislation, the proposal would be effective January 1, 1990.

Analysis

The proposal would bring the treatment of corporations and limited partnerships closer to economic reality while at the same time preserving the reasonable certainty necessary for effective tax planning. The limitation proposed on the number of limited partners corresponds to the current limitation on the number of shareholders permitted in an S corporation.

Tables 1 and 2 contain estimates of the number of limited partnerships and partners that would be affected by the proposal. In 1982, approximately 15,000 limited partnerships -- less than one percent of all partnerships -- would have been taxed as corporations under the proposal. Of these limited partnerships, roughly two-thirds were engaged in two activities, oil and gas drilling and real estate, each of which has generated significant tax shelter activity. The number of partners affected would have been approximately 2.8 million. Of these, over two-thirds would have been partners with interests in oil and gas drilling and real estate.

Limited partnerships reclassified as corporations under the proposal would no longer pass through income or loss to the individual partners. In the case of a profitable limited partnership, the effects of this change on taxes paid would depend on relative corporate and personal income tax rates, the partnership's policy with regard to distribution of income, and the extent to which dividends were subject to double taxation. The Treasury Department proposals include partial relief from the double taxation of corporate earnings distributed as dividends, which could offset the effect on a profitable limited partnership of corporate classification.

In the case of an unprofitable limited partnership, corporate classification would increase tax liabilities. Partnership losses previously available to offset unrelated income of the partners would instead be deductible only against past or future income of the partnership. Under current law, losses could be carried back for three years or carried forward for 15 years against past or future partnership income.

Table 1

Number of Limited Partnerships Affected by Reclassification -- 1982 1/

Industry	Total Number of All Partnerships	Limited Partnerships With More than 35 Partners 2/
All industries	1,514,212	14,896
Agriculture	132,394	171
Mining and Drilling	55,766	3,664
Construction	64,632	13
Manufacturing	23,156	216
Finance and Insurance	155,236	3,272
Real Estate	562,575	6,257
Transportation and Communications	18,185	146
Wholesale and Retail Trade	202,531	93
Services	287,529	1,064

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Office of Tax Analysis

November 30, 1984

1/ Sources: Statistics of Income Bulletin (September 1984); Treasury Department estimates.

2/ Table includes all limited partnerships with more than 35 partners, regardless of whether the partnership has 35 limited partners. To the extent that some limited parnterships have more than 35 partners, but 35 or fewer limited partners, the table overstates the number of partnerships and partners that would be affected by the proposal.

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Table 2

Number of Limited Partners Affected by Reclassification -- 1982 1/

Industry	Total Number of Partners	Total Number of Partners in Limited Partnerships Partners With More than 35 Partners 2/
All industries	9,764,667	2,720,920
Agriculture	448,623	39,938
Mining and Drilling	1,574,375	995,893
Construction	149,600	1,068
Manufacturing	76,649	14,395
Finance and Insurance	2,006,381	483,932
Real Estate	3,720,805	965,611
Transportation and Communications	92,611	32,061
Wholesale and Retail Trade	485,413	4,358
Services	1,171,642	183,664

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Office of Tax Analysis

November 30, 1984

1/ Sources: Statistics of Income Bulletin (Summer 1984); Treasury Department estimates.

2/ See note 2, Table 1.

CHAPTER 8

CAPITAL CONSUMPTION ALLOWANCES

This Chapter discusses one of the most important of the Treasury Department proposals -- replacement of the Accelerated Cost Recovery System and the investment tax credit with a capital cost recovery system that provides annual capital consumption allowances that approximate real economic depreciation. The proposed Real Cost Recovery System would increase productivity, give proper allowance for inflation, eliminate the "front loading" of deductions that encourages tax shelters, and make lower tax rates possible through a broader tax base.

INDEX AND ADJUST DEPRECIATION SCHEDULES

General Explanation

Chapter 8.01

Current Law

The Accelerated Cost Recovery System (ACRS) was established by the Economic Recovery Tax Act of 1981 and generally governs depreciation allowances for tangible property placed in service after 1980. ACRS assigns all "recovery property" to a class with a specified recovery period and depreciation schedule. In general, recovery property is defined to include all depreciable property placed in service after 1980, except intangible property, property subject to amortization, and property for which the taxpayer properly elects a method of depreciation, such as the units of production method, that is not expressed in terms of years.

The pre-ACRS depreciation rules remain in effect for property placed in service by a taxpayer prior to 1981. In general, these rules require taxpayers to recover an asset's original cost less salvage value over its estimated useful life. Taxpayers can elect among several rates of recovery ranging from straight line to methods that are substantially accelerated. Certain taxpayers can elect to depreciate assets under a system employing prescribed industry-wide class lives, with additional rules for salvage values, retirement, repair deductions, and other matters (the ADR system).

ACRS differs from prior depreciation rules in many important respects. ACRS recovery periods are not based on the economic useful life of assets, and for most assets are significantly shorter than under prior law. ACRS employs accelerated depreciation schedules and also allows recovery of full original cost without reduction for salvage value. Thus, for most assets, ACRS allows much faster cost recovery and greater present value depreciation deductions than were obtainable under prior law.

ACRS classifies all personal property (other than public utility property) as three-year or five-year property. Automobiles, light trucks and research and experimentation property are the principal three-year property items, while most other personal property, including machinery and equipment, is recovered over five years. Most real property is classified as 18-year property, although some real property, including real property placed in service prior to March 16, 1984, qualifies as 10-year or 15-year property. Low-income housing is classified as 15-year property. Public utility property may be five-year, 10-year or 15-year property depending upon the class life of such property under prior law.

Under ACRS, foreign property (property used predominantly outside the United States during the taxable year) is subject to longer recovery periods than comparable domestic property. Generally, foreign personal property is recovered over 12 years and foreign real property is recovered over 35 years.

The ACRS depreciation schedules for three-year, five-year and ten-year property are based on the 150 percent declining-balance method switching to the straight-line method. The schedules reflect a half-year convention which halves the first year's depreciation rate regardless of when during the year the property is placed in service. No depreciation deduction is allowed in the year of disposition of personal property.

The depreciation schedule for 18-year real property, except for special transition rules, is based on the 175 percent declining-balance method switching to the straight-line method. The depreciation schedule for 15-year low-income housing is based on the 200 percent declining balance method switching to the straight-line method. First-year depreciation rates for 15-year and 18-year real property are reduced to reflect the number of months during the first year in which property is held in service. Depreciation deductions for real property are allowed for the year of disposition, based on the number of months during which the property was in service for that year.

Under ACRS, the cost of building components, such as air-conditioning and electrical systems, is not recoverable over periods shorter than the building's recovery period. The recovery period for a component generally begins at the later of the time the component or the building is placed in service. The cost recovery for the component is accounted for separately from the building. Substantial improvements to a building are treated as a separate property item entitled to a separate recovery period and depreciation rate.

A lessee who makes capital improvements to leased ACRS property may recover the cost of such improvements over the remaining lease term, if such term is less than the ACRS recovery period. If the lessor and lessee are related parties, however, leasehold improvements must be recovered over the ACRS recovery period, even if the remaining lease term is shorter.

A taxpayer may elect longer recovery periods than the prescribed ACRS recovery period, but in doing so must use the straight-line method for determining the depreciation allowance. A taxpayer may also elect to use the straight-line method over the ACRS recovery period.

Taxpayers may elect to establish mass asset accounts for assets where separate identification is impractical. Only assets of the same recovery class which are placed in service in the same year may be included in a single mass asset account. Gain or loss is not computed upon dispositions of items from a mass asset account, and instead all proceeds from sales of items from a mass asset account are treated as ordinary income. Correspondingly, dispositions do not reduce the unadjusted basis of the mass asset account, so that original cost basis can be fully recovered over the class recovery period.

A special exception to ACRS allows taxpayers to expense a small amount of property used in a trade or business. For taxable years beginning before 1988, a taxpayer may elect to expense a maximum of $5,000 per year. The limit on expensing increases to $7,500 for taxable years beginning in 1988 and 1989 and to $10,000 thereafter. No investment tax credit may be taken on expensed property.

Generally, ACRS depreciation schedules apply to the unadjusted cost basis of an asset. However, if an investment tax credit is taken, the cost basis of an asset must be reduced by 50 percent of the amount of the credit before applying the depreciation rate. Gain or loss is generally recognized on the disposition (including retirement) of ACRS property. Gain or loss is computed with respect to the adjusted basis of property which reflects previously taken depreciation.

ACRS deductions are subject to recapture upon an asset's disposition. For all personal and most real property, all previously allowed depreciation constitutes ordinary income, up to the amount of gain realized. There is no depreciation recapture on property for which a straight-line method has been elected. Only the excess of ACRS deductions over the straight-line method is recaptured on residential rental property, low-income housing and property used predominantly outside the United States.

ACRS does not apply to intangible assets. Amortization allowances are available under current law for intangible assets of limited useful life that are used in a business or held for the production of income. Generally, amortization allowances are computed using a straight-line method. Certain income-producing properties, such as motion picture and television films, may be amortized under the income forecast method which allocates costs proportionately to income expected to be produced.

Reasons for Change

Mismeasurement of Inflation-Adjusted Income. Tax liabilities should be imposed on the basis of real economic income. In the case of investment in depreciable property, measurement of real economic income requires an allowance for the property's economic depreciation. If that allowance is understated, income from the investment is overtaxed and a tax disincentive is created which impairs capital formation and retards the economy's productive capacity. By the same token, overstating depreciation and thus understating income creates an artificial incentive for one form of investment over another, discriminates among companies within an industry, and encourages nonproductive, tax-motivated investment activity.

The proper measure of economic depreciation in any year is the amount of decline in the real value of an asset over the year, which is equal to the cost of replacing the lost productive value. Due to inflationary increases in replacement costs, pre-ACRS depreciation deductions for many assets understated actual economic depreciation and thus resulted in overtaxation of the income from such assets.

The cost recovery system introduced with ACRS eliminated the prior overtaxation of capital investment by providing for more rapid acceleration of depreciation deductions. ACRS, however, continued to base depreciation allowances on historic costs rather than current replacement costs, and thus left the present value of depreciation deductions tied to the rate of inflation. Moreover, at recently experienced levels of inflation, ACRS, in combination with investment tax credits, reduced effective tax rates on investment in depreciable assets substantially below statutory tax rates. Where effective tax rates are reduced substantially below statutory tax rates, the tax system is undertaxing real economic income.

Table 1 displays Treasury Department estimates, based on certain stated assumptions, of average effective tax rates for income from assets in the various ACRS classes. Table 1 demonstrates (1) the substantial extent to which ACRS and investment tax credits reduce effective tax rates, (2) the variance among ACRS classes in the extent to which ACRS and investment tax credits reduce effective tax rates, and (3) the volatility of effective tax rates in response to different inflation rates.

Table 1

Effective Tax Rates on Equity Financed Investments
with Various Rates of Inflation
for 46 Percent Taxpayer Under Current Law 1/

Asset class (years)	Inflation rate (percent) 0	5	10
3	-90	-8	22
5	-51	-3	19
10	-5	20	32
15	9	35	45
18	28	40	45

Office of the Secretary of the Treasury
Office of Tax Analysis
November 23, 1984

1/ Assumptions: Real return after tax is four percent. The investment tax credit selected is the maximum allowable (six percent on three-year equipment and ten percent on five-, ten-, and 15-year equipment). Effective tax rates are the difference between the real before-tax rate of return and the real after-tax rate of return divided by the real before-tax rate of return.

Investment Distortions. The low or negative effective tax rates on ACRS property and the tax deferral resulting from accelerated depreciation allowances distort investment decisions in a variety of ways. First, ACRS disproportionately benefits capital-intensive industries and methods of production. Income from sectors of the economy without significant investment in depreciable property typically face higher effective tax rates. Second, ACRS favors existing businesses over new, start-up businesses, and tax paying businesses over those with tax losses. Accelerated cost recovery allowances are more likely to be used fully by established, profitable businesses than by new companies with substantial start-up costs or by loss companies without net income. The potential unavailability of ACRS benefits may in turn lead to tax-motivated acquisitions or combinations that permit the benefits to be used fully in the year incurred.

Finally, ACRS has fueled the growth of tax shelters. The low or negative effective tax rates on ACRS property, especially in the early years of acquisition, make possible the sheltering of an investor's unrelated income and the accompanying deferral of tax liability. This encourages taxpayers to make otherwise uneconomic investments in order to obtain tax benefits. Also, the prospect of substantial up-front deductions encourages excessive churning of assets.

Investment distortions created by ACRS, investment tax credits and other capital cost recovery provisions hamper economic efficiency. The tax code effectively guides the allocation of capital, overriding private market factors and the individually expressed consumer preferences they represent. This undeclared government industrial policy has grown dramatically in scale and yet it largely escapes public scrutiny or systematic review.

Complexity. As with other provisions that distort accurate measurement of income, the cost recovery rules of current law generate complexity and add to the administrative and enforcement burdens of the Internal Revenue Service. As tax shelter activity has increased due to ACRS and other provisions that mismeasure income, anti-abuse rules have proliferated and the Internal Revenue Service has been required to devote additional resources to policing tax shelter investments. Moreover, whether or not abusive, tax shelters invite disrespect for the tax laws from those who perceive, correctly or not, that the laws are unfair and, hence, not worthy of compliance.

ACRS also contributes to complexity which extends beyond tax shelter investments, affecting potentially every taxpayer. For example, ACRS deductions and investment tax credits must be recaptured upon disposition of depreciable property to prevent ordinary income from being taxed at preferential capital gain rates. The recapture provisions are necessarily complex. While ACRS is not the sole reason for recapture rules, a taxpayer cannot obtain ACRS deductions without being exposed to such complexity.

Uncertainty. ACRS fails to take account of fluctuating inflation rates. As a consequence, taxpayers continue to face uncertainties about the likely effect of inflation on the real after-tax value of a depreciable asset. This, in turn, acts as a depressant on economic activity. Table 1 illustrates the variance of real effective tax rates at different rates of inflation. The certainty of obtaining inflation-proof cost recovery should be an effective stimulus to risk taking and investment.

Proposal

New capital cost recovery rules would be established that explicitly account for inflation and the real economic loss inherent in the use of assets over time. The new Real Cost Recovery System (RCRS) would modify ACRS in several important respects. First, RCRS would allow cost recovery of the real or inflation-adjusted cost of business assets, rather than only the original nominal cost. Second, RCRS would revise the assignment of property among recovery classes. Third, RCRS would assign an invariant percentage rate of depreciation to each recovery class, rather than having rates vary each year as under ACRS. Fourth, the percentage rate of depreciation for each recovery class would be a measure of the estimated decline in economic value. The resulting RCRS depreciation allowances would measure more closely than does ACRS the real economic loss for all assets within a single class.

Under RCRS, all depreciable tangible assets would be assigned to one of seven classes, which would replace the present five ACRS recovery classes. Each RCRS class would be assigned an invariant depreciation rate, ranging from 32 percent to three percent. The depreciation rate would be applied to the indexed basis of an asset, as described below. The depreciation rates assigned to each class of assets and the assignment of types of assets to each class would be designed to minimize the variance in the effective tax rates for all assets, in light of real economic depreciation. Under RCRS, as under ACRS, taxpayers would not estimate useful lives and salvage values for each asset. Intangible assets would not be subject to RCRS and would be amortized generally under current law rules. In addition, assets such as motion pictures, that are depreciable under the income forecast method or other method not measured in terms of years would continue to be depreciable under rules similar to current law.

RCRS would adjust depreciation allowances for inflation by means of a basis adjustment. Under ACRS, only the unadjusted original cost basis of an asset is recovered over the class recovery period. Under RCRS, the remaining unrecovered basis of an asset would be increased each year by the inflation rate and the fixed depreciation rate applicable to the asset's class would be applied against the resulting adjusted basis. The basis of depreciable property not subject to RCRS would be indexed for inflation in a similar manner.

If an asset's basis were adjusted each year for inflation, applying a fixed depreciation rate of less than 100 percent to the adjusted basis would never fully recover such basis. To simplify accounting, RCRS would allow a taxpayer to close out its depreciation account for any asset in a particular class after a specified period of years. The close-out year is not an estimate of the economic useful life of assets in a particular class. The year in which depreciation allowances would be closed out would be the year for each class of assets in which 15 percent of the inflation-adjusted original basis remains to be depreciated. For example, an asset eligible for a 32 percent depreciation rate would be entitled to a 100 percent depreciation rate in the fifth year in which the asset is retained in service. An asset eligible for a 12 percent depreciation rate would be allowed a 100 percent depreciation rate in the 17th year in which the asset is retained in service.

In current dollar terms, the depreciation deduction in the close-out year would exceed substantially the annual deductions allowed in prior years. To mitigate this bunching effect, rules would be provided to spread the amount of the close-out deduction over a period of years. In addition, retirement of an asset prior to the close-out year would be treated as a disposition, upon which a taxpayer would obtain full recovery of an asset's remaining basis and recognize gain or loss.

Under RCRS, taxpayers would pro rate first-year depreciation allowances based upon the number of months assets are placed in service. There would be a mid-month convention for prorating depreciation allowances in the month in which an asset is placed in service. There would be no half-year convention as is applied to personal property under ACRS. A similar pro rating would be required in the year of disposition. There would be no inflation adjustment to basis for purposes of determining depreciation in the year in which an asset is placed in service. There would be a pro-rata inflation adjustment to basis in the year of disposition.

The current law provision permitting taxpayers to elect to expense the aggregate cost of personal property not in excess of $5,000 would be retained. See Chapter 14.01. Vintaged mass asset accounts would also be retained for property qualifying for such treatment under current law. RCRS would retain the current law distinction between deductible repairs and expenditures that appreciably prolong an asset's useful life or materially add to its value, and thus, must be capitalized. Capitalized costs would generally be added to the adjusted basis of the underlying asset, subject to the appropriate partial-year convention or, in some cases, depreciated separately. Each RCRS class would be assigned a safe-harbor repair allowance factor. The safe-harbor would permit expenses incurred after the asset is placed in service to be deducted without challenge, if such expenses are allocable to the asset and do not exceed the product of the asset's remaining inflation-adjusted basis and the repair allowance factor.

Under RCRS, the cost of leasehold improvements that may be deducted by a lessee would be recovered under the general rules applicable to such property, regardless of the term of the lease. However, in the event leasehold improvements are reasonably expected to have no residual value upon termination of the lease term, special rules would be provided to permit different depreciation rates to be applied to such improvements, taking into account the term of the lease (including any renewal options and reasonably expected renewal periods). In the case of leasehold improvements depreciated by a lessee under the general rules, a lessee would treat the termination of a lease as a disposition of the leasehold improvements and would compute gain or loss upon the adjusted basis in such improvements.

The RCRS inflation-adjusted basis of an asset would be used to compute gain or loss on the disposition or retirement of the asset. Since the Treasury Department is also proposing to tax all real gains on sales or dispositions of property as ordinary income, there would be no provision for the recapture of previously taken depreciation. Since no investment tax credits would be available for depreciable assets, there would be no provisions for the adjustment of basis due to such credits or for the recapture of the credits upon early disposition.

Table 2 lists the seven RCRS classes and assigns types of assets to each class. Table 2 specifies the depreciation rate for each RCRS class and the year in which a close-out deduction of all remaining basis may be taken.

The Treasury Department proposes to define the scope of each RCRS class by reference to existing ACRS classes in the following manner. All three-year ACRS property would be classified in RCRS Class 1. All 18-year ACRS property would be classified in RCRS Class 7. In addition, low-income housing, which is 15-year ACRS property, would be classified in RCRS Class 7. All ten-year ACRS property and 15-year public utility property would be classified in RCRS Class 6.

ACRS five-year property would be classified in RCRS Classes 2 through 5. Class 2 would encompass trucks (other than light purpose trucks which are three-year ACRS property), buses, and office, computing and accounting equipment. Class 3 would cover construction machinery, tractors, aircraft, mining and oil field machinery, service industry machinery and equipment and instruments. Class 5 would include railroad equipment, ships and boats, and engines and turbines. All other five-year ACRS property is grouped in Class 4. If an item of machinery, equipment or other property is not described by the asset types listed in Classes 2, 3 and 5, and is not reclassified specifically under the procedure described below, such item would be assigned to Class 4.

The constant depreciation rates for each RCRS class reflect Treasury Department empirical studies showing that a geometric pattern of constant-dollar economic depreciation is generally an appropriate method to apply to all classes of business assets, even though the geometric pattern may not accurately characterize all items within a class. Each of the seven RCRS classes that resulted from the Treasury Department studies is comprised of a group of asset types that, on average, have approximately the same observed geometric rate of economic depreciation. The RCRS classes are organized so as to minimize the variance in observed economic depreciation rates for assets within a class. (Treasury Department studies relied upon "The Measurement of Economic Depreciation," by Charles R. Hulten and Frank C. Wykoff in Depreciation, Inflation, and the Taxation of Income from Capital (ed. C. Hulten, 1981.)

The Treasury Department intends to continue conducting empirical studies of economic depreciation. The proposed RCRS system contemplates that the Treasury Department would establish permanent facilities to conduct these studies. Such studies would gather evidence of changing economic depreciation rates due to such factors as changing technological obsolescence or market conditions. In addition, the Treasury Department would develop data that would enable economic depreciation rates to be measured more precisely for specific

Table 2

RCRS Asset Classes 1/

RCRS Class	Depreciation Rate	Classification of ACRS Property	Close-Out Period (Years) 2/
Class 1	32%	3-year property	5
Class 2	24%	Trucks, Buses and Trailers, Office, Computing and Accounting Equipment	8
Class 3	18%	Construction, Machinery, Tractors, Aircraft, Mining and Oil Field Machinery, Service Industry Machinery, Instruments	12
Class 4	12%	5-year property not assigned to Class 2,3 or 5 including Metal Working Machinery, Furniture and Fixtures, General Industrial Machinery, Other Electrical Equipment, Electrical Transmission/Distribution Equipment, Communications Equipment, Fabricated Metal Products	17
Class 5	8%	Railroad Equipment, Ships and Boats, Engines and Turbines	25
Class 6	5%	10-year property; 15-year public utility property	38
Class 7	3%	18-year property; 15-year low-income housing	63

Office of the Secretary of the Treasury
Office of Tax Analysis
November 30, 1984

1/ Items of property are assigned to RCRS classes under rules described in the text of the General Explanation.

2/ The close-out year is the year in which 15 percent of the inflation-adjusted original basis remains to be depreciated.

asset types. The Treasury Department would review data on economic depreciation and would promulgate regulations to reclassify asset types upon evidence that economic depreciation for an asset type deviates significantly from its class norm. The Treasury Department would also consider whether the depreciation rates for each class should be revised periodically. Pending development of an institutionalized process for reviewing economic depreciation rates, the Treasury Department proposes that ACRS property be classified among RCRS classes in the manner described above.

Effective Date

RCRS would be effective for property purchased on or after January 1, 1986 (other than property purchased pursuant to a binding contract entered into prior to January 1, 1986). Anti-churning rules, similar to those enacted as part of ACRS, would be provided to prevent a taxpayer from treating property owned prior to January 1, 1986, as being subject to RCRS on or after such date. In addition, anti-retention rules would be applied to prevent taxpayers who obtain ownership of assets on or after January 1, 1986, from continuing to account for such assets under ACRS or other prior law. However, assets acquired in tax-free liquidations and reorganizations would not be subject to RCRS if the basis of such assets carries over in the hands of a transferee.

Analysis

Neutral Capital Cost Recovery System. The Treasury Department proposals for the taxation of capital and business income include, principally, RCRS; inflation adjustment of inventories, interest income and expense and gain from the sale of most property; repeal of investment tax credits; and dividend relief. On the whole, these proposals would facilitate a lowering of statutory tax rates to 33 percent for corporations and 35 percent for the highest individual tax bracket. Moreover, RCRS, in concert with other inflation adjustment proposals, would ensure that effective tax rates throughout the economy would not vary significantly from the proposed statutory tax rates. In addition, effective tax rates would remain invariant if inflation were to fluctuate. Thus, RCRS would correct the three principal defects of the capital cost recovery system of current law (see Table 1) -- the substantial reduction in effective tax rates from statutory tax rates; the variance in effective tax rates among different assets and industries; and the volatility of effective tax rates in response to fluctuating inflation.

The economic neutrality among new investments in equipment and structures in different industries that would occur under RCRS is illustrated in Table 3. Under RCRS, the variance of effective tax rates from statutory tax rates across different industries is minor compared to the unsystematic distortions created under current law. There may be some significant variance in effective tax rates of several industries under RCRS, such as farming, mining, and communications. The Treasury Department proposal contains a procedure for periodic adjustment of classifications, if actual effective tax rates under RCRS vary too widely from class norms.

Under RCRS, cost recovery allowances would no longer be front-loaded, as occurs under current law, due to the operation of accelerated depreciation rates and the investment tax credit. However, this does not mean that RCRS would be less valuable to taxpayers than ACRS would be after repeal of the investment tax credit. Tables 4 through 10 list present values of depreciation deductions available over the entire life of an asset under RCRS, ACRS, and straight-line methods. In many cases, RCRS produces a greater inflation-adjusted present value deduction than even ACRS. In all cases, RCRS produces the same present value deduction regardless of inflation rates, while ACRS and straight line methods, which recover original cost only, yield real present value deductions which decrease as inflation increases.

Comparisons of RCRS with current law should also consider the continued tax burden at the corporate and individual levels resulting from the integration of all of the Treasury Department proposals for taxing capital and business income. Table 11 presents the combined effective tax rates at the corporate and individual levels for various cost recovery systems and for the integrated Treasury Department proposal for cost recovery. Table 12 presents the same comparisons of effective tax rates at only the corporate level. In sum, Tables 11 and 12 show that the Treasury Department proposed capital cost recovery system, of which RCRS is a centerpiece, produces approximately the same effective tax rate on income from all forms of investment, while the alternative approaches produce widely varying effective tax rates that depend on the rate of inflation. With respect to many types of property, the Treasury Department proposal is more generous than the alternative approaches, including current law.

Simplicity and Fairness of RCRS. RCRS is designed to correct the previously mentioned defects in ACRS, while at the same time preserving the simplicity of a depreciation system based on relatively few classes of property, each of which would have a single constant depreciation rate to be applied to inflation adjusted basis. The hallmark of RCRS is the more realistic reflection of economic depreciation and thus a fair and more accurate measurement of real economic income.

For purposes of measuring real income, RCRS emphasizes the importance of taking into account not only inflation, but also dynamic factors, such as technological change and changing market conditions, which determine economic depreciation. In modifying the ACRS class-based system, RCRS does not revert to prior flawed methods of depreciation which depended upon determining each asset's useful life, without regard to the pattern of economic depreciation over such life.

The asset types classified in Table 2 are obviously broad categorizations of the myriad of depreciable assets. These asset types are much broader than the categorization of assets under the ADR depreciation system which preceded ACRS. The seven RCRS classes however, are more differentiated and hence, fairer depreciation rates than are obtained under ACRS. ACRS has a single depreciation rate for assets as diverse as computers, service industry machinery and equipment, electrical equipment, and ships. The single ACRS depreciation rate applicable to these diverse assets may be simple in application, but it is neither fair nor conducive of efficient resource allocation.

The classification of assets under RCRS is not more complex than under ACRS. RCRS would be a relatively simple system for taxpayers to comply with and for the Internal Revenue Service to administer. Recordkeeping would be no more involved than under ACRS. Although there would undoubtedly be a need for regulations to refine technical classification of certain items of property, such regulations would not be more complex than existing regulations under ACRS. Class 4 would initially serve as a residual class for five-year ACRS propety not specifically classified in Classes 2, 3, or 5. The Treasury Department expects that further refinement of property classification would be possible as the Treasury Department conducts ongoing studies of economic depreciation for different assets and industries. Thus, the Treasury Department expects that additional items of five-year ACRS property which are classified in RCRS Class 4 could be reclassified among RCRS Classes 2, 3, or 5. Future studies might also justify reclassifying assets in RCRS Classes 1, 6, and 7. Similarly, the Treasury Department would evaluate periodically the appropriateness of depreciation rates and close-out periods assigned to each RCRS Class.

Simplification of Other Tax Provisions. RCRS and other proposed reforms of the capital cost recovery system of current law would permit a substantial simplification of the tax system. Even where some existing rules are retained, their significance and complexity to taxpayers and the Internal Revenue Service would be lessened with a more accurate measure of real income.

RCRS and repeal of the preferential capital gain tax rate would permit repeal of recapture rules. Such repeal would greatly simplify the tax treatment of dispositions of assets. RCRS would also permit repeal of various provisions governing the allocation of depreciation allowances, such as the special tax-exempt leasing rules and special recovery rules for lessees of property, although lessees would be permitted to take RCRS deductions. RCRS in combination with a uniform tax rate on capital and non-capital income would permit repeal of much of the corporate minimum tax. See Chapter 6.02.

RCRS should dramatically reduce the proliferation of tax shelters based on the accelerated capital cost recovery rules of current law. As a consequence, the significance of many anti-tax shelter rules, such as the at-risk rules, would be lessened. Fewer transactions would involve these provisions, enabling Internal Revenue Service enforcement resources to be committed elsewhere.

Table 3

Effective Tax Rates on Equity Financed Investments
in Equipment and Structures by Industry

Industry	Current law 1/ (percent) Inflation rate 5	10	RCRS Earnings 2/ Paid	Held
Agriculture	29	37	16	27
Mining	13	31	24	39
Logging	21	34	19	33
Wood products and furniture	28	38	20	34
Glass, cement and clay	20	31	20	34
Primary metals	16	28	19	33
Fabricated metals	28	38	19	33
Machinery and instruments	26	36	19	33
Electrical equipment	26	38	19	32
Motor vehicles	8	26	19	31
Transportation equipment	25	36	20	34
Food	25	35	19	33
Tobacco	18	30	19	33
Textiles	19	32	19	33
Apparel	28	38	21	34
Pulp and paper	12	26	20	34
Printing and publishing	22	34	19	33
Chemicals	19	32	20	33
Petroleum refining	12	2	19	32
Rubber	18	30	20	34
Leather	30	40	20	33
Transport services	9	26	21	34
Utilities	28	38	22	36
Communications	19	33	24	39
Services and trade	31	40	19	31

Office of the Secretary of the Treasury
Office of Tax Analysis

November 29, 1984

1/ Current law assumes a 46 percent corporate tax rate.

2/ RCRS assumes a 33 percent corporate tax rate.
One-half of paid earnings are deductible.

Table 4

Amount of Depreciation Allowances Under
Alternative Depreciation Schemes for Class 1 Asset 1/
(per $1,000 investment)

Year	RCRS Depreciation Rate 32 Percent Inflation: at 0%	at 5%	at 10%	ACRS 3 Years	Straight-1 3 Years
1	$160	$160	$160	$250	$167
2	269	282	296	380	333
3	183	202	221	370	333
4	124	144	165	0	167
5 2/	264	321	387	0	0
Nominal Total 3/	$1,000	$1,109	$1,229	$1,000	$1,000
Inflation Adjusted Total 4/	$1,000	$1,000	$1,000	$948	$930
Present Value 5/					
0% inflation	$924	N/A	N/A	$957	$944
5% inflation	N/A	924	N/A	908	879
10% inflation	N/A	N/A	924	865	824

Office of the Secretary of the Treasury
Office of Tax Analysis

November 30, 1984

1/ Depreciation is computed on an asset placed in service on July 1 of year 1 by a calendar year taxpayer.

2/ The close-out year deduction would be spread over a period of years, a described in the General Explanation.

3/ Current dollars.

4/ Assumes 5 percent inflation rate.

5/ Assumes a 4 percent real rate of return.

Table 5

Amount of Depreciation Allowances Under
Alternative Depreciation Schemes for Class 2 Asset 1/
(per $1,000 investment)

Year	RCRS Depreciation Rate 24 Percent at 5% inflation	RCRS Depreciation Rate 24 Percent at 10% inflation	ACRS 5 Years	Straight-line 5 Years
1	$120	$120	$150	$100
2	222	232	220	200
3	177	194	210	200
4	141	162	210	200
5	113	136	210	200
6	090	113	0	100
7	072	095	0	0
8 2/	239	330	0	0
Nominal Total 3/	$1,173	$1,383	$1,000	$1,000
Inflation Adjusted Total 4/	$1,000	$1,000	$904	$888
Present Value 5/				
5% inflation	$888	N/A	$837	$810
10% inflation	N/A	888	766	729

Office of the Secretary of the Treasury
Office of Tax Analysis

November 30, 1984

See footnotes for Class 1 asset.

Table 6

Amount of Depreciation Allowances Under
Alternative Depreciation Schemes for Class 3 Asset 1/
(per $1,000 investment)

Year	RCRS Depreciation Rate 18 Percent at 5% inflation	RCRS Depreciation Rate 18 Percent at 10% inflation	ACRS 5 Years	Straight-line 5 Years
1	$90	$90	$150	$100
2	172	180	220	200
3	148	163	210	200
4	128	147	210	200
5	110	132	210	200
6	95	119	0	100
7	81	108	0	0
8	70	97	0	0
9	60	88	0	0
10	52	79	0	0
11	45	71	0	0
12 2/	214	357	0	0
Nominal Total 3/	$1,264	$1,630	$1,000	$1,000
Inflation Adjusted Total 4/	$1,000	$1,000	$904	$888
Present Value 5/				
5% inflation	$847	N/A	$837	$810
10% inflation	N/A	847	766	729

Office of the Secretary of the Treasury
Office of Tax Analysis

November 30, 1984

See footnotes for Class 1 asset.

Table 7

Amount of Depreciation Allowances Under
Alternative Depreciation Schemes for Class 4 Asset 1/
(per $1,000 investment)

Year	RCRS Depreciation Rate 12 Percent at 5% inflation	RCRS Depreciation Rate 12 Percent at 10% inflation	ACRS 5 Years	Straight-line 5 Years
1	$60	$60	$150	100
2	118	124	220	200
3	109	120	210	200
4	101	116	210	200
5	93	113	210	200
6	86	109	0	100
7	80	105	0	0
8	74	102	0	0
9	68	99	0	0
10	63	96	0	0
11	58	93	0	0
12	54	90	0	0
13	50	87	0	0
14	46	84	0	0
15	42	81	0	0
16	39	79	0	0
17 2/	302	635	0	0
Nominal Total 3/	$1,444	$2,192	$1,000	$1,000
Inflation Adjusted Total 4/	$1,000	$1,000	$904	$888
Present Value 5/				
5% inflation	$781	N/A	$837	$810
10% inflation	N/A	781	766	729

Office of the Secretary of the Treasury
Office of Tax Analysis

November 30, 1984

See footnotes for Class 1 asset.

Table 8

Amount of Depreciation Allowances Under
Alternative Depreciation Schemes for Class 5 Asset 1/
(per $1,000 investment)

Year	RCRS Depreciation Rate 8 Percent at 5% inflation	RCRS Depreciation Rate 8 Percent at 10% inflation	ACRS 10-Year	Straight-line 10-Year
1	$40	$40	$80	$50
2	81	84	140	100
3	78	85	120	100
4	75	87	100	100
5	73	88	100	100
6	70	89	100	100
7	68	90	90	100
8	66	91	90	100
9	63	92	90	100
10	61	93	90	100
11	59	94	0	50
12	57	95	0	0
13	55	96	0	0
14	53	97	0	0
15	51	99	0	0
16	50	100	0	0
17	48	101	0	0
18	46	102	0	0
19	45	103	0	0
20	43	105	0	0
21	42	106	0	0
22	40	107	0	0
23	39	109	0	0
24	38	110	0	0
25 2/	455	1,389	0	0
Nominal Total 3/	$1,796	$3,652	$1,000	$1,000
Inflation Adjusted Total 4/	$1,000	$1,000	$819	$791
Present Value 5/				
5% inflation	$697	N/A	$707	$665
10% inflation	N/A	697	603	551

Office of the Secretary of the Treasury
Office of Tax Analysis

November 30, 1984

See footnotes for Class 1 asset.

Table 9

Amount of Depreciation Allowances Under
Alternative Depreciation Schemes for Class 6 Asset 1/
(per $1,000 investment)

Year	RCRS Depreciation Rate 5 Percent: at 5% inflation	RCRS Depreciation Rate 5 Percent: at 10% inflation	ACRS 15-Year	Straight-line 15-Year
1	$25	$25	$50	$33
2	51	54	100	67
3	51	56	90	67
4	51	59	80	67
5	51	61	70	67
6	51	64	70	67
7	51	67	60	67
8	50	70	60	67
9	50	73	60	67
10	50	76	60	67
11	50	80	60	67
12	50	83	60	67
13	50	87	60	67
14	50	91	60	67
15	50	95	60	67
16	49	99	0	33
17	49	104	0	0
18	49	108	0	0
19	49	113	0	0
20	49	118	0	0
21	49	124	0	0
22	49	129	0	0
23	49	135	0	0
24	48	141	0	0
25	48	148	0	0
26	48	154	0	0
27	48	161	0	0
28	48	168	0	0
29	48	176	0	0
30	48	184	0	0
31	48	192	0	0
32	47	201	0	0
33	47	210	0	0
34	47	219	0	0
35	47	229	0	0
36	47	240	0	0
37	47	258	0	0
38 2/	936	5,231	0	0
Nominal Total 3/	$2,725	$9,877	$1,000	$1,000
Inflation Adjusted Total 4/	$1,000	$1,000	$743	$709
Present Value 5/				
5% inflation	$582	N/A	$603	$556
10% inflation	N/A	582	485	430

Office of the Secretary of the Treasury
Office of Tax Analysis

November 30, 1984

See footnotes for Class 1 asset.

Table 10

Current Amount of Depreciation Allowances Under Alternative Depreciation Schemes for Class 7 Asset 1/ (per $1,000 investment)

Year	RCRS Depreciation Rate 3 Percent at 5% inflation	RCRS Depreciation Rate 3 Percent at 10% inflation	ACRS 18-Year	Straight-line 18-Year
1	$15	$15	$50	$28
2	31	33	90	56
3	32	35	80	56
4	32	37	80	56
5	33	39	70	56
6	33	42	60	56
7	34	45	60	56
8	35	48	50	56
9	35	51	50	56
10	36	55	50	56
11	37	58	50	56
12	37	62	50	56
13	38	66	40	56
14	39	71	40	56
15	39	76	40	56
16	40	81	40	56
17	41	86	40	56
18	42	92	40	56
19	42	98	20	28
20	43	104	0	0
30	53	200	0	0
40	63	382	0	0
50	76	731	0	0
63 2/	3,164	56,605	0	0
Nominal Total 3/	$6,633	$81,480	$1,000	$1,000
Inflation Adjusted Total 4/	$1,000	$1,000	$715	$666
Present Value 5/				
5% inflation	$445	N/A	$570	$502
10% inflation	N/A	445	454	377

Office of the Secretary of the Treasury
Office of Tax Analysis

November 30, 1984

See footnotes for Class 1 asset.

REPEAL INVESTMENT TAX CREDIT

General Explanation

Chapter 8.02

Current Law

A credit against income tax liability is provided for a taxpayer's investment in certain depreciable property. Subject to a long list of exceptions, the following classes of property qualify for the investment credit: (1) tangible personal property (other than air conditioning or heating units); (2) certain other tangible property (not including buildings and their structural components); (3) elevators and escalators; (4) single purpose agricultural or horticultural structures; (5) rehabilitated buildings; (6) certain timber property; and (7) storage facilities (not including buildings and their structural components) used in connection with the distribution of petroleum or certain petroleum products.

In general, the credit is equal to ten percent of qualified investment in property that is placed in service during the taxable year. In the case of three-year property, the applicable credit rate is generally six percent. All qualifying costs for new property are eligible for the credit; in the case of used property, the qualifying costs that may be taken into account are generally limited to $125,000 for each taxable year.

The amount of tax liability that may be offset by investment credits in any year may not exceed $25,000 plus 85 percent of the tax liability in excess of $25,000. Credits in excess of this limitation may be carried back three years and forward 15 years.

Reasons for Change

The investment tax credit creates an investment incentive that favors some forms of economic activity over others, discriminates among taxpayers within a single industry, and encourages tax-motivated, noneconomic behavior. Because the investment credit is generally limited to investments in tangible personal property, it favors capital-intensive industries over labor-intensive industries. In addition, the ability of taxpayers to benefit from the credit depends on their having taxable income. Thus, start-up, fast-growing, and loss corporations typically derive less benefit from the credit than existing, profitable corporations in the same industries.

The investment tax credit also distorts investor behavior by skewing the relationship between pre-tax and after-tax returns on investment. Taxpayers are encouraged to invest in activities eligible for the credit or other preferences rather than activities which, in the absence of tax considerations, might produce a greater economic return. The intrusion of tax into economic life is shown most plainly in the numerous tax shelter offerings which depend upon the investment tax credit and certain other deductions and credits for their viability. To the extent taxpayer energy and resources are consumed in pursuing tax rather than economic advantage, the growth and productivity of the economy as a whole are weakened.

Although the concept of the investment tax credit is straightforward, the applicable statutory provisions are exceedingly complex. Repeal of the credit would substantially simplify the tax system by eliminating these complicated rules.

Proposal

The investment tax credit would be repealed. See Ch. 15.01 for a discussion of repeal of the investment credit for rehabilitated buildings.

Effective Date

The proposal generally would be effective for property purchased on or after January 1, 1986 (other than for property purchased pursuant to a binding contract entered into prior to January 1, 1986).

Analysis

Repeal of the investment tax credit would result in more equitable and neutral tax treatment of business taxpayers by eliminating the preferential tax treatment for investments in certain types of assets. Repeal also would eliminate the variations in tax rates among firms that is caused by differences in their capacity to utilize credits. Table 1 shows the industry variations, which are often substantial, in the value of the investment credit. Industries with a low ratio of credit used to credit earned receive less benefit from the investment credit than industries that ordinarily can use the credit immediately. When combined with the impact of accelerated cost recovery, the variation shown in the table probably would be even larger.

Since repeal of the investment tax credit would eliminate the bias in favor of property that is eligible for the credit, investment in such property is expected to diminish. Aggregate business investment, however, should not be diminished. As a result of the benefits accruing to taxpayers from lower overall tax rates and the Treasury Department proposal for an indexed depreciation system, the tax rates on capital in the aggregate would be reduced. See Chapter 8.01.

Repeal of the investment tax credit also would eliminate complexity associated with existing rules (1) to distinguish qualified from non-qualified property, (2) to determine the amount of the credit, (3) to adjust basis as a result of the credit, (4) to determine the amount of previously allowed credits subject to recapture in the event of early disposition of an asset, and (5) to carryback and carryforward unused credits. Other rules also would be repealed: the at-risk rules for the credit, the rules which deny the credit to certain noncorporate lessors, the rules governing pass-through of the credit, the definition of qualified United States production costs and other special rules for films and sound recordings, the rules governing property used by certain tax-exempt entities, the rules pertaining to the treatment of qualified progress expenditures, the rules denying the credit for foreign use property (other than property that meets one of eleven exceptions) and for certain property used in connection with the furnishing of lodging, the rules governing the credit for livestock, the rules governing the credit for certain boilers, and the rules distinguishing used and new property.

Table 1

Utilization of Tax Credits in 1981
($ Millions)

Industry	Investment Credit Earned	Investment Credit Used Against 1981 Tax Liabilities	Rate of Credit Used to Credit Earned (percent)	Unused Investment Credit
All manufacturing	$ 11,327	$ 9,116	80	$ 6,720
Food manufacturing	1,025	831	81	403
Tobacco manufacturing	144	151	105 1/	0
Textile mill products	146	125	86	83
Apparel	60	56	93	25
Lumber and wood	309	48	16	392
Furniture and fixtures	38	30	79	14
Paper products	373	303	81	207
Printing and publishing	482	345	72	218
Chemicals	1134	872	77	653
Petroleum and refining	2,332	2,295	98	209
Rubber and plastic	132	111	84	120
Leather products	20	19	95	4
Stone, clay and glass	264	148	56	242
Primary metals	492	649	132 1/	981
Fabricated metals	447	326	73	229
Machinery	1,166	938	80	420
Electrical equipment	1,081	631	58	1,080
Motor Vehicles	865	739	85	877
Transportation equipment	418	123	29	501
Instruments	296	293	99	24
Other manufacturing	103	81	79	42
Utilities	4,844	3,047	63	7,939
Other Sectors	9,831	6,649	68	8,022
Total	$26,002	$18,812	72	$ 22,681

Office of the Secretary of the Treasury
Office of Tax Analysis

November 30, 1984

1/ Percentage greater than 100 indicates that credits were carried forward and used from previous years.

CHAPTER 9

ADJUSTMENTS FOR EFFECTS OF INFLATION

Current law is woefully inadequate in making allowances for the effects of inflation. Provisions designed to compensate for inflation create further distortions and rarely achieve their goal with any degree of accuracy. In other cases, such as the taxation of interest income and expense, current law makes no adjustment for inflation.

Even at moderate inflation levels, the failure to reflect inflation in the measurement of capital income significantly distorts decisions regarding capital investment. This Chapter discusses Treasury Department proposals that, together with the rules for indexing depreciation allowances discussed in Chapter 8, would adjust the tax system for inflation on a relatively comprehensive basis.

INDEX CAPITAL ASSETS

General Explanation

Chapter 9.01

Current Law

Gains or losses from the sale or exchange of capital assets held for more than six months (one year for assets acquired before June 23, 1984) are treated as long-term capital gains or losses. Long-term capital gains receive preferential tax treatment. For individuals and other noncorporate taxpayers, 60 percent of net capital gain is excluded from income, with the balance of 40 percent taxable at ordinary rates. Thus, a taxpayer in the maximum 50 percent tax bracket has a marginal tax rate on net capital gain of 20 percent. For corporations, the regular maximum tax rate of 46 percent is reduced to 28 percent on net capital gain if the tax computed using that rate is lower than the corporation's regular tax.

A taxpayer determines net capital gain by first netting long-term capital gain against long-term capital loss and short-term capital gain against short-term capital loss. The excess of any net long-term capital gain over any net short-term capital loss equals net capital gain entitled to the preferential tax rate.

Capital losses are deductible under different rules for corporate and noncorporate taxpayers. For corporations, any net short-term or long-term capital loss is offset against any net long-term or short-term gain. Excess capital losses are not deductible but may generally be carried back for three taxable years and forward for five taxable years as a short-term capital loss in the carryover year.

Individuals and other noncorporate taxpayers also deduct any net short-term or long-term capital loss first against any net long-term or short-term gain. In addition, a noncorporate taxpayer with an excess net capital loss may generally take up to $3,000 of such loss as a deduction against other income. For this purpose, only one-half of net long-term capital loss is usable. Net capital loss in excess of the deduction limitations may be carried forward indefinitely, retaining its character in the carryover year as either a short- or long-term loss.

A capital asset is defined generally as property held by a taxpayer other than (1) inventory, stock in trade, or property held primarily for sale to customers in the ordinary course of the taxpayer's trade or business, (2) depreciable or real property used in the taxpayer's trade or business, (3) rights to literary or artistic works held by the creator of such works, or acquired from the creator in certain tax-free transactions, (4) accounts and notes receivable, and (5) certain publications of the government.

Special rules apply to gains and losses with respect to "section 1231 property" and "section 1256 contracts." Section 1231 property is defined as (1) depreciable or real property held for more than six months and used in a taxpayer's trade or business, but not includible in inventory or held primarily for sale in the ordinary course of a trade or business, (2) property subject to compulsory or involuntary conversion, and (3) special industry property, including timber, coal, domestic iron ore, certain livestock and certain unharvested crops. Gains and losses from all transactions involving section 1231 property are netted for each taxable year. If there is a net gain from section 1231 property, all gains and losses from section 1231 property are treated as long-term capital gains and losses and are combined with the taxpayer's other capital gains and losses. If there is a net loss from section 1231 property, all transactions in section 1231 property produce ordinary income and ordinary loss.

Section 1256 contracts are defined to include (1) any regulated futures contract, (2) any foreign currency contract, (3) any nonequity option, and (4) any dealer option. Gain or loss with respect to a section 1256 contract generally is treated as 60 percent long-term capital gain or loss and 40 percent short-term capital gain or loss.

Subject to certain exceptions, capital gains and losses are taken into account when "realized," generally by sale, exchange or other disposition of the property. Section 1256 contracts generally are treated as if sold on the last business day of the taxable year in which held and accrued gains or losses are realized upon such deemed sales. Certain dispositions of capital assets, such as transfers by gift, are not realization events for tax purposes. Thus, in the case of gifts, no gain or loss is realized by the donor, and, in general, the donor's basis in the property carries over into the hands of the donee. Gain or loss also is not realized on transfer at death, even though the transferee's basis in the property is stepped-up to fair market value at the time of death.

The amount of a seller's gain or loss is equal to the difference between the amount realized by the seller and the seller's adjusted basis (i.e., the cost or other original basis adjusted for items chargeable against basis). Under various nonrecognition provisions, however, realized gains and losses in certain transactions are deferred for tax purposes. Examples of such nonrecognition transactions include certain like-kind exchanges of property, involuntary conversions followed by an acquisition of replacement property, corporate reorganizations, and the sale of a principal residence within two years of the acquisition of a new principal residence. Generally, nonrecognition treatment defers gain or loss for tax purposes by providing for a substitution of basis from the old property to the new or for a carryover basis from the old holder to the new holder.

Reasons for Change

Measurement of Income. Tax liabilities should be imposed on the basis of real economic income. During periods of inflation, nominal gains or losses on sales of capital assets will reflect inflationary increases in the value of property which do not represent real changes in economic value. Current law, however, computes capital gains and losses by reference to historic investment cost, unadjusted for inflation, and thus overstates capital gains or understates capital losses to the extent of inflation during the period property is held before sale.

The current preferential tax rate for capital gains has often been justified as an allowance for the overstatement of capital gains caused by inflation. The preferential rate actually serves this purpose only sporadically. The effects of inflation accumulate over time, yet the preferential tax rate does not vary with the holding period of an asset (beyond the minimum 6 months or one year) or with the actual rates of inflation during such period. As a result, the preferential rate undertaxes real income at low rates of inflation and overtaxes capital gains at higher rates of inflation; for any inflation rate, the longer an asset is held the greater is the undertaxation of real income. Moreover, the preferential rate does not prevent taxation of inflation-caused nominal gains in circumstances where the taxpayer has in fact suffered an economic loss.

Because the preferential tax rate does not account accurately for the effects of inflation, investors currently face substantial uncertainty regarding the eventual effective rate of tax on their investments. Such uncertainty poses unnecessary and incalculable risks for investors and thus impairs the capital formation needed for economic growth.

Neutrality. The preferential tax rate for capital gains also distorts investment decisions by providing a potentially lower effective rate of tax on assets that offer a return in the form of asset appreciation rather than current income such as dividends or interest. Along with other provisions that establish special tax treatment for particular sources and uses of income, the preferential tax rate for capital gains is one of an elaborate series of tax incentives for particular businesses and investments. These incentives impede the efficiency of an economy based on free market principles. This undeclared government industrial policy largely escapes public scrutiny, yet it increasingly controls the form and content of business and investment activity.

Simplification. The sharp distinction in tax rates under current law between capital gains and ordinary income has been the source of substantial complexity. Application of different tax rates to different sources of income inevitably creates disputes over which assets are entitled to the preferential rate and encourages taxpayers to mischaracterize their income as derived from the preferred source. A significant body of law, based both in the tax code and in judicial rules, has developed to deal with these matters. Its principles are complicated in concept and application, typically requiring careful scrutiny of the facts in each case. The taxpayer and Internal Revenue Service resources consumed in this process are substantial, yet there is little basis for confidence that the results derived in particular cases are even roughly consistent.

Proposal

The preferential tax rate for long-term capital gains would be repealed. Gains and losses from sales of property would no longer be classified as either capital gains and losses (i.e., gains and losses from sales of capital assets) or ordinary gains and losses. Thus, net capital gain as defined under current law would be fully includible in taxable income and subject to tax at regular rates. Moreover, the holding period of property would no longer affect the tax treatment of gains or losses from sales.

Repeal of the preferential tax rate for capital gains would be coupled with inflation adjustment for realized gains from sales or other dispositions of property. For property other than inventory assets or debt instruments, a taxpayer's original cost basis would be indexed for inflation during the period a taxpayer holds the property. Computation of the basis adjustment for inflation is explained below. Assets required to be inventoried would not be indexed under the rules proposed here, but would be subject to inflation adjustment under the method of inventory accounting elected by the taxpayer. See Chapter 9.02. Inflation adjustment for bonds, notes and other debt instruments would be accomplished by indexing interest payments rather than the basis in the indebtedness. See Chapter 9.03. The above rules for indexing of basis would in general be available not only for U.S. taxpayers but also for property held by nonresident aliens and foreign corporations. In addition, conforming changes would be made in the current rules governing taxation of nonresident aliens and foreign corporations to take account of the elimination of the current law capital asset concept.

As applied to tax-favored retirement plans, the proposal would permit indexing of basis with respect to nondeductible employee contributions for purposes of determining the taxable

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portion of distributions from such plans. No indexing would be permitted with respect to tax deductible contributions by an employee or employer not included in income.

Losses from sales of investment property would remain subject to limitations. Excluding personal use property, losses from sales of property other than investment property could be deducted without limitation. In general, investment property would be defined as all nonpersonal use property other than (1) property used in a trade or business, (2) inventory property and property held primarily for sale to customers in the ordinary course of business, (3) a general partnership interest, or (4) an interest in an S corporation in which the holder actively participates in management of the entity. For purposes of these loss limitation rules, investment property would generally include notes, bonds and other debt instruments. For noncorporate taxpayers, losses from sales of investment property would offset gains from such property, with any excess loss deductible up to a maximum of $3,000 in each taxable year. Investment property losses in excess of this limitation could be carried forward indefinitely. For corporate taxpayers, investment property losses would offset gains from such property, but would not be otherwise deductible. Excess losses from sales of investment property by a corporation also could be carried forward indefinitely.

The proposal would not alter the basic realization and nonrecognition rules of current law. Thus, a taxpayer would take inflation-adjusted gains and losses into account only when realized upon a sale, exchange or other disposition of property. Current law rules regarding taxable realization events would be retained. Thus, a taxpayer would generally recognize gains or losses at year-end on section 1256 contracts, but would not recognize gain or loss upon gratuitous transfers of property, whether inter vivos or upon death. As under current law, the donor's basis and holding period for purposes of inflation adjustment would carry over in the case of inter vivos gifts. In the case of transfers of property at death, the donor's basis would be stepped-up to fair market value and the transferee would start anew the holding period for indexing such basis.

Nonrecognition provisions of current law, which require realized gains or losses to be deferred, would also generally be retained. In particular, homeowners would be permitted, subject to existing rules, to roll over gain on the sale of a principal residence, if a new principal residence is acquired within 2 years of the sale of the prior principal residence. Moreover, subject to existing rules, homeowners who are age 55 or older would exclude permanently the first $125,000 of inflation adjusted gain upon the sale of a principal residence.

The proposal generally would retain current law rules relating to determination of the amount realized upon a sale, exchange, or disposition of property. In particular, current law rules concerning the amount realized in respect of liabilities (recourse or nonrecourse) assumed or taken subject to upon disposition of property would be retained.

The Internal Revenue Service would implement the indexing proposal by publishing inflation tables using the Bureau of Labor Statistics' Consumer Price Index for Urban Households. These tables would contain inflation adjustment factors which would be applied to the original cost basis to determine the inflation adjusted basis. The tables would specify inflation adjustment factors by calendar quarters that an asset was held. Thus, a taxpayer who bought an asset in the third quarter of 1984 and sold the asset in the second quarter of 1990 would locate in the tables a single inflation adjustment factor to be applied to the original cost basis. The tables would contain inflation adjustment factors back to January 1, 1965. Assets obtained prior to that date would be indexed as if acquired on that date.

The inflation adjustment factors would be computed using a half-quarter convention, which would allow only half the applicable quarterly inflation rate regardless of when during a quarter an asset was acquired or sold. An asset would be required to be held for one full calendar quarter in order to qualify for indexing. Assets held only for one full quarter would obtain an inflation adjustment factor only for that full quarter, and not for the partial quarters in which acquired and disposed of.

If assets are used in a trade or business that employs a functional currency other than the U.S. dollar, the measure of inflation generally would be based on the inflation rate in the functional currency (as determined by the Internal Revenue Service).

Effective Date

The proposal would be effective on January 1, 1986 for all assets purchased on or after that date (other than assets purchased pursuant to a binding contract entered into before January 1, 1986). Thus, assets purchased on or after January 1, 1986 would be subject to indexing from the date of purchase; in addition, gains or losses from such assets, whenever recognized, would be taxed under the new rules of the proposal.

Different transition rules would apply to depreciable and nondepreciable assets purchased before January 1, 1986 ("old depreciable assets" and "old nondepreciable assets," respectively). For old nondepreciable assets, there would be a three year transition period, beginning on January 1, 1986, during which gain or loss would be computed without indexing of basis. In general, gains or losses during this period from old nondepreciable assets would be taxed under the principles and effective tax rates of current law. Thus, net capital gain from such assets would be subject to partial exclusion, with the amount of exclusion calculated to produce approximately the same maximum rate under current law of 20 percent. Thus, if the maximum individual marginal tax rate during this period is 35 percent, the fractional exclusion for all taxpayers would be 43 percent. Similarly, corporations would be eligible for an alternative rate that, in relative terms, would approximate the available current law rate of 28 percent.

During the three year transition period, taxpayers holding certain old nondepreciable assets would be allowed an election to realize gain or loss without a sale or other disposition. This mark-to-market election could be exercised only with respect to assets which are regularly traded on an established market, such as a stock or commodity exchange. If the mark-to-market election is not exercised and the taxpayer holds old nondepreciable assets on January 1, 1989, the basis of those assets is indexed as of that date (for post-1964 inflation).

The one-time mark-to-market election would permit taxpayers to determine at any time during the transition period whether they are better off realizing gain by applying the preferential tax rate to unindexed basis or by indexing historic basis (post-1964) and applying the uniform marginal tax rate. Thus, the transition period affords a taxpayer electability of tax treatment for readily marketable assets which would be retained after the transition period closes. Assets that were marked-to-market during the transition period would be indexed only from the date of the mark-to-market election.

Old nondepreciable assets sold on or after January 1, 1989, would be fully subject to the proposals. Thus, gain or loss from such assets would be determined by reference to an inflation adjusted basis (indexed for inflation back to the date of purchase, but not earlier than January 1, 1965). No mark-to-market election would be available on or after January 1, 1989.

Sales and other dispositions of old depreciable assets during the three year transition period would be taxed under current law principles. Thus, gains from the sale of old depreciable assets would be subject to recapture as ordinary income under current law recapture rules. Net capital gain from old depreciable assets sold during the transition period would be taxed in the same manner as net capital gain from old nondepreciable assets during the transition period. That is, net capital gain would be subject to partial exclusion at a rate calculated to maintain the same maximum tax rate of 20 percent for individuals. In general, net losses from sales of old depreciable assets during the transition period would be deductible in full, as under current law.

For sales of old depreciable assets after the transition period ends on January 1, 1989, gains would be taxed in two parts. First, all depreciation not in excess of realized gain (computed with respect to the asset's basis without adjustment for inflation) would be recaptured and subject to tax at regular tax rates. Second, the excess, if any, of such realized gain over the recapture amount would be adjusted for inflation by indexing the original cost basis of assets using the published inflation adjustment factors. Thus, the excess of the amount realized on the sale over the inflation adjusted original cost basis would be taxed at the regular tax rate. After the transition period, losses from the sale of old depreciable assets (computed with respect to the basis of assets unadjusted for inflation) would be deductible in full.

Analysis

Effect on Saving and Investment. Under most circumstances, the proposal would either hold roughly constant or reduce effective tax rates on realized capital gains; the proposal should thus either have no or a somewhat stimulative effect on saving and investment. At current rates of inflation (four percent in 1983 and 1984), most high-bracket taxpayers would be subject to roughly the same effective tax rate on long-term capital gains as under current law (i.e., a maximum rate of 20 percent on nominal gains). At rates of inflation experienced in recent years (an average annual rate of 7.9 percent between 1972 and 1982), the proposal would reduce significantly the effective tax rate on most real capital gains. This is shown by Table 1, which provides maximum effective tax rates on real capital gains under current law for various combinations of inflation rates, rates of real appreciation, and holding periods.

Also, indexing would eliminate the current volatility in effective tax rates that accompanies inflation; the associated reduction in uncertainty should stimulate saving and investment. The "insurance" benefits of a tax system which guarantees an explicit inflation adjustment should not be minimized. For example, inflation averaged seven percent annually between 1971 and 1975. Over the same period, nominal capital gains on sales of corporate stock totaled $24.6 billion. Once adjusted for inflation, however, these sales actually represented a loss of $0.4 billion.

Finally, indexing capital gains for inflation would produce more accurate measurement of real losses; the associated increase in government risk-sharing should also stimulate saving and investment.

Effect on risk-taking. The effect of capital gains taxation on private risk-taking in the economy is of critical importance. The venture capital and associated high-technology industries seem particularly sensitive to changes in effective tax rates.

Shareholders in some ventures--those which are highly successful over short periods of time--would face higher effective tax rates under the proposal. Nevertheless, more accurate measurement of economic losses and the reduction of inflation caused variations in effective tax rates would stimulate investment generally. Moreover, a maximum marginal tax rate of 35 percent on indexed gains would produce effective rates that are not substantially above those experienced during the last two venture capital booms. (Tax rates of 25 percent during the 1960s and 28 percent from 1978-81 on nominal gains were actually higher effective rates due to inflation.) In addition, all investors would continue to benefit from the deferral of tax on accrued but unrealized gains.

Also, the increase in saving stimulated by reductions in individual marginal rates and expansion of IRAs, as well as the elimination of many industry-specific tax preferences and the enactment of measures to reduce the advantages of investment in unproductive tax shelters, should increase the supply of capital available to high technology industries.

Housing. The indexing proposal should not, on balance, significantly affect the housing industry or the desire of individuals to invest in their own homes. Most capital gains in the housing industry have been inflationary gains that would not be subject to tax under the indexing proposal. Moreover, the proposal retains the provisions of current law permitting taxpayers to roll over realized gains on the sale of a principal residence and granting a one-time exclusion of $125,000 on the sale of a principal residence by taxpayers over the age of 55. Indeed, the one-time exclusion would be more generous under the proposal since it would apply to inflation-adjusted rather than nominal gains.

Retention of Realization Requirement. The proposal would retain the realization requirement of current law, under which gains and losses generally are not taxed until realized by sale, exchange or other disposition. One of the consequences of the realization requirement is that tax on accrued but unrealized gains is deferred, except in the case of section 1256 contracts. The tax advantage of deferring gains creates an incentive for taxpayers to continue to hold appreciated assets in order to avoid realizing gain. This so-called "lock-in" effect impairs capital resource allocation to the extent taxpayers are deterred from reallocating investments by the tax costs of realizing accrued appreciation.

Indexing mitigates the lock-in effect of the realization requirement by ensuring that only real gains are taxed. Under current law, unrealized inflationary gains cause a lock-in effect as much as unrealized real gains. Moreover, although the proposal eliminates the preferential tax rate for capital gains, the Treasury Department proposals include a reduction in marginal tax rates that reduces the current law distinction between capital gain and ordinary income. On balance, the relative significance of the lock-in effect under the indexing proposal versus current law depends on prospective rates of inflation. Since the lock-in effect cannot be eliminated fully in any system that retains the realization concept, the gains in certainty and measurement of income attributable to indexing and the distortions caused by a rate differential override concerns over the lock-in effect.

The proposal retains the mark-to-market accounting concept currently applicable to section 1256 contracts. The primary advantage of the mark-to-market concept in this limited context is that it negates the need to identify offsetting positions for purposes of the loss deferral rules applicable to straddles. Straddle transactions utilizing section 1256 contracts would provide numerous opportunities for abuse for taxpayers with large volumes of trades in such contracts absent retention of mark-to-market accounting for these assets.

Scope of Loss Limitation Rules. In general, the proposal would retain the capital loss limitation rules of current law for assets held for investment and not for use in a trade or business. Such limitations are appropriately applied to investors who may selectively realize gains and losses on investment assets.

Simplification. Repealing the preferential tax rate on capital gains and taxing all inflation-adjusted income at uniform tax rates would eliminate a source of substantial complexity in current law. Schemes to convert ordinary income to capital gain would be deprived of their principal tax motivation. For example, use of a so-called "collapsible corporation" as a device to convert ordinary income into capital gain from a sale or exchange of stock would no longer be abusive. Thus, current law's collapsible corporation provisions and related provisions concerning collapsible partnerships could be repealed.

Depreciation recapture has been necessary under ACRS and prior depreciation rules to prevent excessive depreciation deductions from being converted into capital gain. Indexing depreciation allowances and gains and losses from dispositions of property obviates the need for depreciation recapture provisions. Excessive depreciation would be "recaptured" as ordinary income, which (assuming no intervening change in the taxpayer's marginal tax rate) would substantially restore the tax benefit derived from the original deduction. Although the taxpayer would continue to receive a timing advantage where RCRS allowances exceed economic depreciation, taxing all recapture income as ordinary income would permit repeal of the recapture provisions for depreciable property acquired after the proposals become fully effective.

Beyond the benefits of repealing provisions rendered superfluous, repeal of the preferential tax rate would reduce the scope of disputes between taxpayers and the government and would inevitably curb or reverse the growth of rules -- legislative, judicial and administrative -- intended to confine the preferential treatment of capital gains within certain bounds. Although legal uncertainties would not be eliminated, the tax stakes in subsequent disputes would be substantially reduced, easing the pressures that have spawned complexity under current law.

INDEX INVENTORIES

General Explanation

Chapter 9.02

Current Law

In general, current law requires the use of inventory accounting methods where necessary to determine clearly a taxpayer's income. Treasury regulations implementing this rule generally require inventories to be maintained where the production, purchase or sale of merchandise is an income-producing factor. A taxpayer that keeps inventories for tax purposes must use the accrual method of accounting with respect to purchases and sales of inventory items.

Inventory accounting assists in accurately measuring income from the sale of goods; this measurement, in turn, depends on the value for tax accounting purposes of the goods on hand at the close of the taxable year. The cost of goods sold during the year is generally equal to the dollar value of beginning inventory, plus purchases and other inventoriable costs incurred during the year, minus the dollar value of ending inventory. Thus, a taxpayer with beginning inventory of $100, purchases and other inventoriable costs of $500, and ending inventory of $150, has a cost of goods sold for the year of $450 ($100 plus $500 minus $150 = $450). The measurement of income from the sale of goods changes with any change in the valuation of ending inventory. Thus, if ending inventory, in the preceding example, had a higher value, the cost of goods sold would have been lower, and gross income from sales would have been correspondingly higher. Conversely, a lower figure for ending inventory would have increased the cost of goods sold and reduced gross income.

Under Treasury regulations, inventories generally are valued at cost, although in certain cases the lower of cost or market value is permitted. In order to determine the cost of ending inventory the goods on hand at year-end must be identified. In making this determination, a taxpayer may identify each specific item of inventory and ascertain its actual cost or value. In most cases, however, this "specific identification" method is impractical because of the number and fungible nature of the goods on hand. The Code and regulations therefore permit alternative methods which employ simplifying assumptions regarding the flow of goods from inventory.

The first-in, first-out (FIFO) method assumes that the first goods purchased or produced are the first goods sold. Under FIFO the most recently produced goods are deemed on hand at year-end, and ending inventories are thus valued at the most recent purchase or production costs. The last in, first-out (LIFO) method assumes that the last goods purchased or produced are the first goods sold. Since LIFO accounting values ending inventory at the oldest purchase or production costs, in periods of increasing purchase or production costs its use results in higher cost of goods sold and lower taxable income than FIFO.

Since 1939, taxpayers who use the LIFO method for tax purposes have been required to use LIFO in preparing annual financial statements for credit purposes and for reports to stockholders, partners, proprietors or beneficiaries (the "LIFO conformity requirement").

Reasons for Change

Taxes should be imposed on real economic income, not on increases that are attributable to inflation. Current inventory accounting methods depart from this principle by failing to reflect inflation in a consistent manner.

Because the LIFO method treats the most recently acquired goods as the first goods sold, LIFO accounting reflects income from inventory sales more accurately during periods of inflation than FIFO. Notwithstanding the advantages of the LIFO method in an inflationary economy, many businesses nevertheless use the FIFO method. Some businesses find that the use of LIFO for financial accounting purposes -- as required by the LIFO conformity requirement -- is unacceptable. Whatever the original reasons for the LIFO conformity requirement, it is not appropriate in a tax system designed to neutralize the effects of inflation. Many small firms are reluctant to use the LIFO method because they view LIFO as significantly more complex than FIFO.

Although LIFO better accounts for the effects of inflation than FIFO, it does not fully account for these effects. LIFO takes account only of price changes in the inventoried goods, which may or may not correspond to the effects of inflation on prices generally. Moreover, since LIFO represents only a flow of goods assumption rather than an adjustment of inventory costs in line with inflation, it results in only the deferral rather than the elimination of inflationary gains. When a firm that uses the LIFO method either liquidates or reduces inventories, it is taxed on previously deferred inflationary gains. This factor distorts business decisions and creates a tax bias in favor of transactions such as mergers and reorganizations which permit continued deferral of the inflationary gain.

Proposal

Taxpayers would be permitted to use an Indexed FIFO method in addition to the current LIFO and FIFO methods of accounting. Under the Indexed FIFO method, inventories would be indexed using inflation adjustment factors based on the Consumer Price Index. Indexing would be based on relatively simple computational methods, such as applying the percentage increase in the Consumer Price Index to the FIFO cost of the number of units in beginning inventory which does not exceed the number of units in ending inventory. Indexing would be permitted only with respect to inflation occurring after the effective date of the proposal. The requirement under current law that the Internal Revenue Service consent to changes in accounting methods would be waived for taxpayers changing to LIFO or to Indexed FIFO accounting methods during an appropriate transition period. In addition, the LIFO conformity requirement would be repealed.

Effective Date

The proposal would be effective for taxable years beginning on or after January 1, 1986.

Analysis

About two-thirds of inventories in the United States are owned by firms which continue to use FIFO accounting, despite the resulting overstatement of income tax liability during inflationary times. Table 1 provides data on the use of FIFO by industry group. Repeal of the LIFO conformity requirement would permit such firms to switch to either Indexed FIFO or LIFO inventory tax accounting, while continuing to use the FIFO method for financial accounting purposes. It is expected that taxpayers that currently use the FIFO method would switch to the Indexed FIFO method or the LIFO method. An immediate switch by all firms that currently use FIFO to either Indexed FIFO or LIFO would result in a maximum aggregate annual tax saving to those firms of approximately $6 billion.

Firms that currently use LIFO, however, would be unlikely to change to Indexed FIFO, unless the economic advantages were sufficient to offset the associated administrative costs as well as the tax costs resulting from recapture of LIFO reserves. LIFO inventories would not be eligible for an inflation adjustment under the capital asset indexing proposal described at Chapter 9.01. Such an adjustment would generally be inappropriate because the LIFO inventory valuation merely reflects a flow of goods assumption; it does not purport to reflect the taxpayer's historic cost of the physical goods on hand. Moreover, those using LIFO have benefitted in the past relative to taxpayers using FIFO as a result of this flow of goods assumption. It would provide a further relative tax advantage to those using LIFO to permit their inventories to be indexed. For LIFO firms that do switch to Indexed FIFO, inventory stocks would thereafter be valued more accurately. Moreover, distortion of decision-making with respect to liquidations of firms and reductions in inventories would be reduced.

The proposal to index the FIFO method would improve the measurement of income for tax purposes since inflationary gains would be permanently removed from the tax base. The Indexed FIFO method also would be more consistent with the proposed system for indexing depreciation than other methods of inventory accounting. In particular, for firms that elected the Indexed FIFO option, economic gains and losses on inventory would be included in the tax base. This treatment would be analogous to the proposed treatment for depreciable assets, where depreciation allowances would be indexed for general inflation.

Finally, the current disincentive to entry into industries that have historically used the FIFO accounting system and thus borne an artificially high tax burden would be removed.

Table 1

Percentage of Ending Inventory Valued by the FIFO Method by Industry 1/

Industry	Value of Ending Inventory ($Billions)	Percentage FIFO (%)
Agriculture	4.6	97
Mining	8.2	81
Construction	23.1	97
Food	24.0	66
Tobacco	6.7	15
Textiles	5.8	50
Apparel	8.3	82
Lumber	6.0	77
Furniture	6.0	77
Pulp and Paper	6.5	60
Printing and Publishing	5.4	70
Chemicals	26.4	50
Petroleum	23.9	41
Rubber	5.1	63
Leather	2.1	74
Stone, Clay and Glass Products	5.9	58
Primary Metals	20.7	39
Fabricated Metals	20.7	39
Machinery	38.9	67
Electrical Equipment	30.1	68
Motor Vehicles	16.1	47
Instruments	8.2	57
Transportation Equipment	18.3	78
Transportation Public Utilities	31.9	92
Communications	6.5	99
Wholesale Trade	108.8	80
Retail Trade	102.2	69
Finance, Insurance, and Real Estate	12.8	89
Services	11.0	95
Total All Industries	594.2	70

Office of the Secretary of the Treasury
Office of Tax Analysis

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1/ Source: 1981 Corporation Income Tax Returns, computed by the Bureau of Economic Analysis

INDEX INDEBTEDNESS

General Explanation

Chapter 9.03

Current Law

As a general rule, a borrower can deduct all interest paid or accrued on indebtedness. Interest is ordinarily deductible by the borrower whether the indebtedness is incurred in the conduct of a trade or business, in connection with an income-producing investment, or in financing personal consumption. Interest incurred to carry or acquire tax-exempt bonds is not deductible, however, and limitations apply to the deductibility of interest incurred to produce investment income.

Corresponding to the general deductibility of interest incurred, interest received by or credited to a holder of indebtedness is fully includible in income and taxable at ordinary income rates. Interest received on certain obligations of State and local governments, however, is exempt from Federal income tax.

In general, the making of a loan and the satisfaction of indebtedness are not taxable events for Federal income tax purposes. Thus, a debtor does not have income upon the receipt of the principal amount of a loan or a deduction when such principal amount is repaid. Similarly, the principal amount of a loan is neither a deductible amount to the lender when the loan is made nor an item of income when it is repaid. If indebtedness is discharged at less than its face amount, the debtor may recognize discharge of indebtedness income and the lender ordinarily recognizes a loss.

Reasons for Change

Over time inflation erodes the value of a creditor's claim for repayment of an indebtedness with a fixed principal amount, and the debtor's liability to repay principal is correspondingly reduced. Debtors and creditors routinely take account of the anticipated effects of inflation on a lending transaction by adjusting the rate of interest charged. Thus, nominal interest rates typically include an inflation component which compensates the lender for the anticipated reduction in the real value of an obligation of a fixed dollar amount; as to the borrower, this payment is an offsetting charge for the inflationary reduction in the value of the principal amount of the borrowing.

Because the inflation component of nominal interest payments is, in effect, a repayment of principal, the current treatment of nominal interest payments as fully deductible by the debtor and fully taxable to the creditor mismeasures the income of each. These inaccuracies in the measurement of income distort a variety of investment decisions, greatly increasing the significance of tax considerations in such matters as the allocation of investment funds between debt and equity and between long-term and short-term financing. Moreover, in a progressive tax system, overstatement of interest expense and income accentuates the existing incentive for lower tax-bracket taxpayers (including tax-exempt institutions) to be net creditors and higher tax-bracket taxpayers to be net borrowers. This so-called "clientele effect" occurs because the tax savings from interest deductions is greater for high-bracket borrowers than is the increased tax liability from interest income to low-bracket lenders. This clientele effect is aggravated during times of high inflation and corresponding high nominal interest rates.

The failure of the current tax system to recognize and measure the inflation component of nominal interest payments also accentuates the economic effects of variable inflation on debtors and creditors. If the rate of inflation increases unexpectedly, a creditor with fixed-interest indebtedness suffers an economic loss, and the debtor has a corresponding economic gain. These changes in economic position are compounded by the treatment of interest under current law, since the entire amount of nominal interest payments remains deductible or includible in income regardless of changes in the inflation rate. The resulting mismeasurement of income in an economy with variable inflation spawns economic uncertainty. Such uncertainty likely contributes to reduced levels of savings, investment and risk-taking.

Finally, the overstatement of interest under current law encourages borrowing for investments in which income is tax exempt or tax deferred. For example, the investment of borrowed funds in capital assets produces a current deduction for interest expense but no realization of the increase in value of the capital asset until its sale or disposition. This mismatching of income and expense from related transactions understates current income and thus permits the deferral of tax. Overstatement of interest expense thus increases the extent to which debt-financed tax shelter investments can be used to offset taxable income from other sources.

Proposal

Interest would be indexed for tax purposes by excluding a fractional amount of interest receipts from income and denying a deduction for a corresponding fraction of interest payments. For example, with a fractional exclusion rate of 25 percent, taxpayers would include in income only 75 percent of otherwise taxable interest receipts and deduct only 75 percent of otherwise deductible interest payments. The fractional exclusion rate would be based on the annual inflation rate, as explained below.

In general, the proposal would apply the fractional exclusion rate to a taxpayer's net interest income or net interest expense, subject to the following exceptions. First, an individual would deduct any mortgage interest on indebtedness secured by or allocable to his or her principal residence. Qualifying mortgage indebtedness for this purpose could not exceed the fair market value of the principal residence. Next, an individual would net aggregate gross interest expenses (excluding home mortgage interest) against aggregate gross interest income (excluding tax-exempt interest). An individual with net interest expense would apply the fractional exclusion rate to the amount of interest expense in excess of $5,000 ($2,500 in the case of a married person filing a separate return). Interest expense, after any reduction by the fractional exclusion rate, would be deductible. See Chapter 16.01, however, relating to limitations on the deduction of investment interest. An individual with net interest income would apply the fractional exclusion rate to such net interest income. Interest income, after reduction by the fractional rate would be includible in income.

All of a corporation's interest income and expense would be subject to the fractional exclusion. Interest incurred by a partnership or other pass-through entity would be treated as incurred by the partner or other person to whom the payments are allocable.

Interest received by a partnership or other pass-through entity would be treated as received by the partner or other person reporting such payments.

Tax-favored retirement plans, such as an individual retirement account or qualified pension plan, which earn interest income would not be able to pass on the benefit of the fractional exclusion to the plan beneficiaries. Thus, the fractional exclusion rate could not be claimed with respect to distributions from tax-favored retirement plans. See Chapter 9.01 for application of the basis indexing rules to retirement plans.

The fractional exclusion rate would be modified annually to reflect changes in the rate of inflation, as measured by the Bureau of Labor Statistics' Consumer Price Index. The proposed relationship between fractional exclusion rates and inflation rates is set forth in Table 1. The proposed relationship set forth in Table 1 is based on an assumption of a constant six percent real, before-tax interest rate. Assumption of lower real interest rates would result in higher exclusion rates for any given inflation rate. The fractional exclusion rate for a taxpayer that uses a functional currency other than the U.S. dollar should be based on the inflation rate in the foreign currency.

Table 1

Fractional Exclusion Rate

Inflation Rate (Percent)	Fractional Exclusion Rates (Percent) 1/
0	0
1	14
2	25
3	33
4	40
5	45
6	50
7	54
8	57
9	60
10	62
11	65
12	67

Office of the Secretary of the Treasury
Office of Tax Analysis

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1/ Fractional exclusion rate is determined by assuming a constant, six percent real interest rate (rate of return).

The proposal would not alter the current law definition of interest. The current law rules which impute interest income in certain transactions would also be retained.

Effective Date

The proposal to index interest payments and receipts would become effective January 1, 1988 and would apply to all indebtedness regardless of when incurred. The delay in effective date would mitigate the effects of the change in the tax treatment of interest paid and received on existing loans.

Analysis

Indexing Interest Rather than Principal. An ideal measure of real economic income for tax purposes would recognize the inflationary reduction in principal on a loan as creating loss for the creditor and income for the debtor on an annual basis. That ideal system departs from the realization doctrine of current law, however, under which mere changes in the value of an asset, including a debt instrument, do not trigger income or loss. Abandonment of the realization doctrine in this context would introduce substantial costs in complexity and recordkeeping.

Inflation's impact on indebtedness may be indirectly accounted for, however, without departing from the realization doctrine. Instead of computing inflationary gain or loss on principal, the effects of inflation can be approximated by indexing interest payments and receipts through application of the proposed fractional exclusion rate.

For example, A borrows $100 from B on January 1, agreeing to pay back the principal plus ten percent interest on December 31. Over the course of the year, there is four percent inflation and the real, pre-tax rate of return is six percent. On December 31, A satisfies its indebtedness by repaying the $100 principal and $10 in interest. B's receipt of the $100 in principal actually represents a loss of $4 in real purchasing power. B's receipt of $10 in nominal interest, however, actually represents a $6 real return on the loan, plus a $4 inflationary component which offsets the reduction in the value of the $100 principal. Thus, in this example, a fractional exclusion rate of 40 percent would be appropriate.

The example demonstrates that, in theory, the effects of inflation on indebtedness may be reflected for tax purposes either by indexing principal or indexing interest. Indexing interest retains the realization rules of current law, and is a much more administrable system.

Determining the Fractional Exclusion Rate. In a world with but one nominal interest rate, real interest income and expense would be accurately measured by a fractional exclusion rate equal to the ratio of the inflation rate to the nominal interest rate. With such an exclusion rate, the excluded interest payments and receipts would correspond to the inflationary component of nominal interest.

The proposal's single fractional exclusion rate for each inflation rate obviously oversimplifies the relationships between inflation and nominal interest rates in a diverse economy. The real rate of return earned on indebtedness will differ from lender to lender. The proposal's economy-wide fractional exclusion rate, however, allows a more accurate measurement of real economic income than does current law, which implicitly provides a zero fractional exclusion rate for all interest.

Effects on Nominal Interest Rates. The proposal would likely result in lower nominal interest rates than would prevail under current law for any given set of economic conditions. For any expected inflation rate, lenders would not demand as high an inflation premium since the inflation component of nominal interest receipts would not be taxed. Similarly, borrowers would be less willing to pay a high inflation premium, since the inflation component of nominal interest payments would not be tax deductible. Accordingly, nominal interest rates would likely fall, relative to levels that would prevail under current law for any given economic conditions. Whether interest rates would actually fall after enactment of the proposal would, of course, depend upon factors beyond the tax laws, such as monetary policy and international capital flows.

The proposal also likely would result in reduced volatility of interest rates with respect to changes in inflation. Under the proposal, a change in inflation should induce a smaller change in nominal rates than would occur under current law.

Effects of the Exceptions to Fractional Exclusion Rate. The proposal would not apply the fractional exclusion rate to all deductible interest payments, resulting in some asymmetric treatment of borrowers and lenders. Homeowners would be permitted full deduction of mortgage interest on a principal residence, while mortgagees would be entitled to apply the fractional exclusion rate to interest received on home mortgages. All individuals would be allowed full deduction (without indexing) of the first $5,000 of other net interest expense. Although these exceptions depart from theoretical symmetry for all interest payments and receipts, their retention facilitates the transition from an unindexed to an indexed tax system. The exception for home mortgages, however, would create an incentive for taxpayers both to mortgage the existing equity in their homes, and to disguise consumer, investment or business indebtedness as increases in home mortgages. These opportunities for tax arbitrage present serious revenue concerns, and it may be necessary to develop strict rules to prevent such schemes from circumventing the intent of the exception.

Characterization of Non-Interest Payments as Interest. Indexing interest receipts and excluding a portion of such receipts from income may lead taxpayers to try to characterize certain periodic payments as partially excludable interest rather than fully taxable income such as rents or royalties. Some disincentive for mischaracterization exists, since treatment of payments as interest would limit the interest deduction available to the payor. Nevertheless, payors and payees in different tax brackets could produce a net tax savings by mischaracterizing payments as interest.

Current law has substantial experience with attempts to mischaracterize payments as interest, principally with regard to the characterization of corporate distributions as interest or dividends. No single, mechanical approach to such questions is likely to prove satisfactory, and it is contemplated that the response to abusive cases would evolve under current doctrines distinguishing between substance and form.

The interest exclusion could also encourage overstatement of interest rates in deferred payment transactions in order to characterize profit on the sale as excludable interest. Although similar incentives can exist under current law, for example, in deferred payment transactions involving nondepreciable property, much greater attention has been focused on transactions in which interest is understated in order to take advantage both of front-loaded ACRS deductions and of the current favorable treatment of capital gains.

In order to limit overstatement of interest, stated valuations and interest rates would be measured against comparable transactions and disregarded where unrealistic. Although not part of the proposal, it could eventually be appropriate to establish mechanical limits on maximum interest rates analogous to the imputed interest rules of current law.

Interaction with Other Proposals. Indexing interest receipts and payments is consistent with the Treasury Department proposals relating to inflation indexing for capital gains, RCRS property and inventories. Since both interest receipts and stock in a corporation holding interest-bearing assets would be adjusted for inflation, there might be some question of a potential for over-indexing or of double counting for inflation. In general, however, no such double counting would occur, since it is appropriate that the corporation's income and the shareholder's return on stock be separately adjusted for inflation.

Because the fractional exclusion rate is not a precise measure of inflationary effects, interest generally would not be excluded in the same proportion as a shareholder or partner would be allowed to index basis in stock or a partnership interest. Even though not precisely accurate, the fractional exclusion rate comes closer to achieving the appropriate correspondence between a shareholder's basis in a corporation's stock and the corporation's income from indebtedness than would a system that failed either to index the shareholder's stock basis or to apply the fractional exclusion to the corporation's interest income.

The variation between basis indexing and application of the fractional exclusion rate could in some cases be exploited by taxpayers if future variations could be known with sufficient certainty. Such exploitation seems to present the greatest likelihood of taxpayer manipulation in the case of pass-through entities holding a substantial proportion of interest bearing assets. In such cases, partners would be precluded from increasing basis in their partnership interests faster than at the rate implied by the fractional exclusion rate applied to the partnership's interest receipts. In other cases, similar limitations on indexing stock may be required to ensure that the relationship between indexing capital assets and indebtedness is not abused.

CHAPTER 10

INCOME MEASUREMENT

Significant strides were made in the Deficit Reduction Act of 1984 toward accruately reflecting the "time value of money" in measuring taxable income. This Chapter discusses proposals that would continue these improvements. Areas addressed in the 1984 legislation were generally not reevaluated.

The Treasury Department proposals would require production costs to be capitalized on a more comprehensive basis, providing a more accurate matching of income and expenses. Accounting methods that mismeasure income, such as the cash method of accounting and the installment method, would be limited. Finally, the deduction for additions to bad debt reserves would be repealed.

REVISE ACCOUNTING RULES FOR MULTIPERIOD PRODUCTION

General Explanation

Chapter 10.01

Current Law

In General

Where a taxpayer produces inventory or property that is not sold during the current year the costs of production generally may not be currently deducted. Rather, these costs must be added to the taxpayer's basis in the property to which they relate. If the product is sold, these capitalized costs are recovered against the selling price. If the product is a durable good that is used in the taxpayer's business, the costs are recoverable as depreciation, amortization, or depletion deductions. The general principle that production costs must be capitalized is not uniformly applied in all contexts. In some cases production costs may be currently deducted. In others, where current tax accounting rules require production costs to be capitalized, the costs included within the definition of "production costs" vary substantially depending on the type of property produced and the method of production.

Production Costs Other than Interest

a. **Inventories**. In accounting for inventories of manufacturers or producers, costs must be collected according to the full absorption method of inventory accounting. All direct costs and certain indirect costs must be capitalized. Indirect costs that are not required to be included in inventoriable costs include, for example: depreciation and amortization reported for Federal income tax purposes in excess of depreciation reported in the taxpayer's financial reports, and general and administrative expenses incident to and necessary for the taxpayer's activities as a whole.

The treatment of certain indirect costs varies depending on how such costs are treated in the taxpayer's financial reports ("financial-conformity indirect costs"). These costs must be capitalized only if the taxpayer capitalizes them in its financial reports. Included in this category of indirect costs are: taxes, depreciation and cost depletion attributable to assets incident to and necessary for production; pension and profit-sharing contributions and other employee benefits; costs attributable to rework labor, scrap and spoilage; factory administrative expenses; salaries paid to officers attributable to services performed incident to and necessary for production; and insurance costs incident to and necessary for production.

Long-term contracts. Long-term contracts are building, installation, construction, or manufacturing contracts that are not completed within the taxable year in which they are entered into. Taxpayers using the completed-contract method of accounting for long-term contracts may not deduct contract costs until the contract is completed and income is reported. The rules for determining which costs must be treated as contract costs differ from the full absorption costing rules applicable to inventory. In addition, different rules apply depending on the duration of the contract.

For many long-term contracts the costs that must be capitalized generally track the full absorption regulations as they apply to a manufacturer that capitalizes in its financial reports the financial-conformity indirect costs. Differences are as follows: pension contributions and other employee benefits need not be capitalized; costs attributable to strikes, rework labor, scrap, and spoilage need not be capitalized; and research and experimental expenses directly attributable to particular contracts must be capitalized.

In the case of "extended-period long-term contracts," proposed regulations provide that taxpayers must capitalize certain additional long-term contract costs. With certain exceptions, extended-period long-term contracts are contracts that take more than two years to complete. The additional costs that must be capitalized include:

- all depreciation, amortization, and cost recovery allowances on equipment and facilities used in the performance of particular extended-period long-term contracts (tax depreciation in excess of depreciation reported on financial statements need not be capitalized in the case of non-extended-period contracts);
- depletion (whether or not in excess of cost) incurred in the performance of particular extended-period contracts;
- pension contributions and other employee benefits;
- rework labor, scrap, and spoilage incurred in the performance of particular extended-period contracts;
- expenses of successful bids; and
- certain direct and indirect costs incurred by any administrative, service, or support function or department to the extent allocable to particular extended-period contracts.

Proposed regulations set forth detailed rules for allocating administrative, service, and support costs to particular extended-period long-term contracts. The general test is whether a particular function or department of the taxpayer benefits the extended-period long-term contracts, or merely benefits the overall management or policy guidance functions of the taxpayer.

Self-constructed assets. The costs of constructing or improving property having a useful life substantially beyond the taxable year must be capitalized and added to the basis of the property constructed. Existing regulations do not spell out which costs are to be capitalized when the construction is undertaken by the taxpayer to construct property for its own use. The Supreme Court has held that depreciation on equipment used in such construction has to be capitalized, and other courts have required certain indirect expenses, such as vacation pay, payroll taxes, certain fringe benefits, and certain overhead costs to be capitalized. Although administrative and judicial interpretations provide some guidelines, it is not clear in many self-construction cases whether particular costs may be deducted or must be capitalized.

Farming. Most farmers are not required to keep inventories for tax purposes, and thus do not capitalize the costs of producing crops. All of these costs may be deducted in the year when paid. The same is generally true of the costs of raising long-lived plants and animals, such as fruit and nut trees or breeding livestock. The costs of acquiring the seedlings or immature animals generally may not be deducted, however. The rule allowing a current deduction for most production costs originated from a concern not to impose an undue recordkeeping burden on farmers.

Some farmers are required to capitalize certain production costs. Under section 447, certain farming corporations must take inventories into account in computing income, and accordingly are effectively denied a current deduction for production costs to the extent reflected in increased inventory. Section 447 does not apply to S corporations, corporations that are 50-percent owned by one family, or corporations with gross receipts of $1,000,000 or less. The provision is also inapplicable to certain corporations that were closely held to a requisite extent on October 4, 1976, and were engaged in farming on that date. In addition to requiring use of the accrual method and inventory accounting for tax purposes, section 447 requires the preproductive period expenses of raising long-lived plants and livestock to be capitalized. Preproductive period expenses are defined as any amount (other than interest and taxes) which is attributable to the preproductive period of crops, animals, or any other property having a crop or yield. In the case of property having a useful life of more than one year that will have more than one crop or yield, the preproductive period is the period before the disposition of the first marketable crop or yield. In the case of any other property having a crop or yield, the preproductive period is the period before the property is disposed of.

Farming syndicates engaged in developing a grove, orchard, or vineyard in which fruit or nuts are grown must capitalize the expenses of these activities under section 278(b). Instead of including the entire period before the disposition of the first marketable crop, the period during which expenses must be capitalized includes only the period before the first taxable year in which the grove, orchard, or vineyard bears a crop or yield in commercial quantities. Under proposed regulations, farming syndicates need not capitalize the following expenses: real estate taxes, interest, soil and water conservation expenditures that are deductible under section 175, and expenditures for clearing land allowable as a deduction under section 182.

Under section 278(a), expenses attributable to the development of any citrus or almond grove incurred before the close of the fourth taxable year beginning with the taxable year in which the trees were planted must be capitalized. This provision is not restricted to farming syndicates. As under section 278(b), interest, taxes, soil and water conservation expenditures, and expenditures for clearing land need not be capitalized.

Timber. Some costs of producing timber are not deductible when paid or incurred, but may be recovered only when the timber is sold. These include planting costs (site preparation, seed or seedlings, labor and tool expenses, and depreciation on equipment) and costs of silvicultural practices incurred before the seedlings are established. All other production costs may be currently deducted, including carrying costs (such as property taxes), costs of silvicultural practices after establishment of the seedlings, costs of disease and pest control, fire protection expenses, insurance, and management costs (including labor and professional costs, costs of materials and supplies, and costs of timber cruises for management purposes, but not timber cruises in connection with the purchase of timber).

Capitalization of Construction-Period Interest

Real property construction-period interest and taxes may not be currently deducted, but must be amortized over ten years. If the property is sold before all the expenses are recovered, the unrecovered expenses are added to basis in determining gain on the sale. The provision does not apply to low-income housing, or to property that cannot reasonably be expected to be held in a trade or business or in an activity conducted for profit. Construction-period interest includes any interest expense that could have been avoided if construction expenditures had been used to repay indebtedness.

Construction-period interest relating to personal property may be deducted currently.

Reasons for Change

Current tax rules do not always match taxable receipts and deductions relating to production activities. This failure to match is particularly egregious in the case of production that extends beyond one taxable year ("multiperiod production"), and becomes more significant with longer production periods. The mismatching of receipts and expenses permits deductions from these activities to offset income from other activities. A large number of tax shelters involve the so-called "natural deferral" industries, such as timber, extractive industries and vineyards. Proposals directed at particular production costs incurred in the extractive industries are discussed in Chapter 11.

Production expenses that relate to income to be produced in future periods should be matched with that income by capitalizing the production costs. Current tax accounting rules do not require comprehensive capitalization of costs. Most importantly, the current rules do not require the capitalization of interest paid with respect to the cost of carrying multiperiod production investments to completion. When these costs are not capitalized, the producer gains tax deferral and the equivalent of an interest-free loan from the Federal government.

The current tax accounting rules requiring production expenses to be capitalized differ by type of activity. Long-term contracts, self-constructed assets and inventories all have different rules. Replacement of the several different income tax accounting rules by a uniform rule would make the income tax system more neutral and fairer.

Uniform capitalization rules would also eliminate tax distortions across activities. The current rules encourage businesses to construct their own assets rather than to purchase them even when they are not the most efficient producers. A seller prices goods by reference to all costs, including those deducted for tax purposes, plus a reasonable profit. The tax basis of a purchased asset, therefore, includes all costs of production, both direct and indirect, and these costs are recoverable by the purchaser only when sold or through depreciation, amortization, or depletion allowances. In contrast, the tax basis of a self-constructed asset includes only certain direct costs and perhaps a few indirect costs, while all other costs are deducted currently.

In addition to distorting investment decisions, the present rules cause serious unfairness. The benefits of tax deferral tend to be reflected in the prices of the products produced by multiperiod processes. Because the value of the tax deferral is related to the marginal tax rate of the investor, the attractiveness of these activities as tax shelters crowds out low-bracket individuals, as "shelter investors" bid-up the costs. Low tax rate individuals find they cannot earn a market after-tax rate of return at the price established by "shelter investors."

In sum, present law applies incomplete capitalization rules nonuniformly to different types of multiperiod production and applies rules that vary according to whether the output is sold or used in the producer's own business. These rules violate the principle of tax neutrality and should be modified.

Proposal

Capitalization of production costs other than interest. Uniform rules for capitalizing production costs would apply in all cases where the costs of producing or constructing real or personal property must be capitalized. The following types of production activities would be subject to the uniform capitalization rules:

- the production or manufacture of goods to be held in inventory or for sale to customers in the ordinary course of business;

- production under a long-term contract;

- the construction or other production of real or tangible personal property (including improvements to property) having a useful life beyond the taxable year, whether such property is to be used in the taxpayer's business or held for investment ("self-constructed assets");

- the growing of timber; and

- the development of the productive capacity of oil and gas and other mineral property.

Special rules, described below, would apply to Federal government contracts and to farming. Rules governing the development costs of oil and gas and other mineral property are discussed in detail in Chapter 11.

The expenses of a particular production activity that would have to be capitalized would generally include all direct and indirect costs of production, as set forth in the rules currently applicable to extended-period long-term contracts, described in detail above. Major expenses that would not have to be capitalized as production costs include:

- marketing, selling, and advertising expenses;

- research and development expenses unrelated to particular production activities;

- expenses of unsuccessful bids and proposals; and

- general and administrative expenses other than those properly allocable to particular production activities.

General and administrative expenses attributable to certain Federal government contracts would have to be capitalized. This requirement would apply to all cases where the contractor is required by statute or regulation to submit certified cost data in connection with the award of the contract. Federal statutes generally require certified cost data to be submitted in connection with contracts the price of which is expected to exceed $100,000 (effective March 31, 1985). This rule does not apply where the contract is awarded on the basis of sealed bids; where there is adequate price competition; or where the price is an established catalog or market price or is set by law. In addition, general and administrative expenses would have to be capitalized where the contract price is based in whole or in part on the contractor's costs which include general and administrative expenses, i.e. so-called cost-plus and similar contracts.

This specific requirement to capitalize general and administrative expenses would apply only with respect to contracts with Federal agencies. General and administrative expenses required to be capitalized would not include marketing, selling, and advertising expenses, research and development expenses unrelated to particular contracts, or expenses of unsuccessful bids and proposals.

Special rules would apply to farmers. No farmers would be required to keep inventories for tax purposes if not currently required to do so. With respect to preproductive period expenses, the rules of section 447 would continue to apply to the taxpayers currently covered by that provision (except in the case of property subject to section 278, revised as described below). The principles of section 278(b), which deals with the capitalization of the development costs of fruit and nut orchards and vineyards, would be extended to apply generally to any plant or animal whose preproductive period was two years or longer. The new provision would apply to all taxpayers, not just farming syndicates. The preproductive period would begin with the time the plant or animal was first planted or acquired by the taxpayer, and would end with the time that the plant or animal became productive or was disposed of. For example, in the case of a taxpayer developing an orchard, the preproductive period would begin with the time the seedlings or saplings were purchased by the taxpayer, and would end with the time the tree first bore fruit. If the preproductive period were two or more years long, the preproductive period expenses would have to be capitalized. The types of expenses that must be capitalized would be defined comprehensively as above.

Capitalization of construction-period interest. Construction-period interest would have to be capitalized in the case of self-constructed property with a long useful life, and in the case of any property whose production period was two years or longer. With respect to self-constructed property, construction-period interest would have to be capitalized if it relates to long-lived property (property included in RCRS Class 5, 6, or 7). In determining whether the production period is two years or longer, the period would generally begin with the commencement of construction or production and end with the time when the property is ready to be placed in service or held for sale. In the case of property produced under a long-term contract, the production period would end with contract completion. Interest attributable to the raising of plants or animals whose preproductive period was two years or longer would also have to be capitalized. Interest attributable to self-constructed assets to be used by the taxpayer for personal purposes (such as residential real estate) would not be subject to the capitalization requirement.

Construction-period interest would be defined as any interest expense of the taxpayer that could be avoided if production or construction expenditures were used to repay indebtedness. Production or construction expenditures would be defined as equal to the cumulative production costs required to be capitalized. In effect, as under current-law rules defining construction-period interest, the taxpayer's interest cost is deemed first allocable to production or construction activities. Appropriate related-party rules would be provided.

A customer of a contractor making progress payments or advance payments would be treated as self-constructing the property under construction by the contractor to the extent of such payments. Thus, payments and other advances by a customer would be treated as the customer's construction or production expenditures, and the contractor's construction or production expenditures would be reduced to this extent. The customer would have to capitalize interest attributable to such payments, if the constructed property were in RCRS Class 5, 6, or 7, or if the construction period were two years or longer. To the extent of such advances by the customer, the contractor would not be treated as having incurred construction expenses, and would accordingly not have to capitalize construction-period interest. The contractor would have to capitalize construction-period interest on only the excess, if any, of the accumulated contract costs over the accumulated advances or progress payments.

In cases where interest is required to be capitalized, the amount added to the basis of the property being constructed would be the amount of interest expense, adjusted for inflation by applying the exclusion ratio. See Chapter 9.03. The basis of such property would be eligible for indexing, under the rules set forth in Chapter 9.01, during the production period and thereafter. In the case of a contractor, contract costs up to the amount of advance payments made by the customer would not be eligible for indexing as far as the contractor is concerned, but would be treated as self-construction by the customer.

Effective Date

Except as provided below, the proposed rules concerning production cost accounting and the capitalization of interest would be effective generally for costs and interest expense paid or incurred on or after January 1, 1986. The new rules would not apply to long-term contracts entered into before 1986. Production costs (including interest) attributable to timber that was planted before 1986 that are not required to be capitalized under present law would have to be capitalized under a ten-year phase-in. Thus, 10 percent of such costs paid or incurred in 1986, 20 percent of such costs paid or incurred in 1987, etc., would have to be capitalized. With respect to inventories, the new rules would apply for the taxpayer's first taxable year beginning on or after January 1, 1986. In order to minimize large distortions in taxable income of taxpayers subject to the new inventory cost accounting rules, such taxpayers would be allowed to spread the adjustment that results from the difference between the use of the new and previously used methods of accounting for production costs ratably over a period not to exceed six taxable years in accordance with the usual rules for change in method of accounting initiated by the taxpayer and approved by the Internal Revenue Service.

Analysis

Capitalization of costs means that instead of being allowed to deduct production costs currently, the costs would be recovered when the produced property is sold or through depreciation, amortization or depletion deductions as the property is used in the taxpayer's business. The capitalization of costs incurred in the purchase or construction of a capital asset matches those expenses with the reporting of taxable income.

When capital costs are not capitalized, deductible expenses are not matched with the receipt of the taxable income they serve to produce. The acceleration of expenses allows other taxable income to be sheltered by deductions, and taxable income is deferred until later years. When tax liability can be deferred, the taxpayer benefits from an interest-free loan from the Federal government. Deferral reduces the taxpayer's effective tax rate, and can be passed on to consumers in the form of lower prices.

Interest is a significant expense of long-term production that generally is not required to be capitalized under current law. Because interest expenses are a fraction of other expenses incurred in short-term production activity, the proposal would generally require capitalization of interest only where the production period occurs over several years. However, interest incurred in relatively short-term production of long-lived self-constructed assets would have to be capitalized, because allowing a current deduction for such costs would excessively accelerate deductions when compared with capitalization. Because of the fungibility of money, it is necessary to make certain assumptions as to the amount of interest attributable to production. Under the proposal, any debt outstanding would be attributed first to construction costs associated with the long-term production activity. The same rule applies in defining construction-period interest under current law.

Uniform rules for the capitalization of production costs would make the tax code less distortionary across activities. Uniform rules would also place all long-term production activities on a consistent tax accounting basis, and reduce tax-induced distortions in constructing and acquiring capital assets.

Special rules would recognize the peculiarities of certain industries. Thus, the current rules that do not require farmers to use inventories in computing income with respect to most crops would be retained, so as not to impose an undue recordkeeping burden. In the case of certain plants and animals that take a long time to mature, however, production costs would have to be capitalized, to avoid a significant deferral of tax liability.

The special rule requiring certain Federal contractors to capitalize general and administrative expenses is appropriate because these contractors are paid for such overhead costs as part of the contract price. While it is generally not an easy matter to determine what portion of the overhead costs of a business are properly allocable to a contract, this determination is not difficult in the case of contractors who directly bill the Federal government for the overhead or rely on the allocated overhead in setting the contract price. The current system allows such contractors to be paid for the overhead costs under the contract, but to currently deduct such costs for tax purposes as current period costs that purportedly have nothing to do with the contract. Allowance of a current deduction for such costs results in tax deferral because the associated payments are not included in income until the contract is completed. The proposal would put Federal tax accounting on a consistent basis with Federal contract cost accounting. The current-law rules effectively subsidize Federal government contracts, thus causing the apparent cost of such contracts on the outlay side of the budget to be understated. Truth in budgeting calls for the subsidy to be removed and the full costs to be reflected in outlays.

TREAT PLEDGES OF INSTALLMENT OBLIGATIONS AS PAYMENTS

General Explanation

Chapter 10.02

Current Law

Income from an installment sale is reported as payments are received, rather than in the year of sale, unless the taxpayer elects otherwise. In general, an installment sale is a disposition of property where at least one payment is to be received after the close of the taxable year in which the disposition occurs. The gain recognized for any taxable year is the proportion of the installment payments received in that year which the gross profit to be realized when payment is completed bears to the total contract price. In general, the total contract price is the amount that will be paid to the seller.

Any indebtedness assumed by the buyer which is not "qualifying indebtedness" is treated as a payment in the year of sale or disposition. Qualifying indebtedness is treated as a payment in the year of sale only to the extent that it exceeds the seller's basis in the property. The term qualifying indebtedness means (1) a mortgage or other indebtedness encumbering the property, and (2) indebtedness incurred or assumed by the seller incident to the seller's acquisition, holding, or operation of the property in the ordinary course of business or investment.

If the seller disposes of an installment obligation, the tax that has been deferred on the installment sale generally becomes due. However, if a taxpayer pledges an installment obligation as collateral for a loan, he may, under some circumstances, continue to defer his tax on the sale.

Reasons for Change

The installment method was intended to alleviate liquidity problems that might arise if a taxpayer was required to pay tax on a sale when he had not received all or a portion of the sales proceeds. Under current law, however, a taxpayer generally may defer his tax liability on an installment sale, even if he obtains cash by using the installment note as collateral for a loan. For example, a taxpayer who sells property for $100,000, payable in ten years with market rate interest payable annually, can pledge the note as collateral for a loan of, say, $90,000 from a bank. The interest payments received from the buyer on the installment obligation provide the taxpayer with funds to make interest payments on the $90,000 loan from the bank. Thus, the taxpayer has the use of $90,000 for ten years, but is not required to pay any tax on his gain from the sale until receipt of payment from the buyer in ten years. Under current law, the note from the buyer could be secured by a bank letter of credit, thus making the transaction essentially riskless for the seller. In such a case, the taxpayer obtains the benefit of the profit element on the sale and has sufficient cash to pay the tax liability. There is no reason to permit such a taxpayer to continue to defer tax liability on the sale.

If instead of pledging the installment note after the sale of the property, the taxpayer had pledged the property for a loan prior to the sale and the buyer had assumed the taxpayer's indebtedness, the amount of the indebtedness (in the case of qualifying indebtedness, the excess over basis) would have been treated as a payment in the year of sale. Similar rules should apply regardless of whether the indebtedness is incurred before or after the sale.

Proposal

Any amount borrowed that is secured by an installment obligation would be treated as a payment on the installment note. In the case of an amount borrowed in the ordinary course of the taxpayer's business and secured by an installment note received for the sale of goods in the ordinary course of business, only the excess of the borrowed amount over the taxpayer's basis in the installment note (i.e., the profit element) would be treated as a payment. Exceptions would be provided for short-term borrowings and certain bank borrowings secured by a general lien on all of the borrower's assets.

Effective Date

The proposal generally would be effective for installment notes pledged as security on or after January 1, 1986. As of January 1, 1991, the proposal would apply to installment notes that were pledged prior to January 1, 1986.

Analysis

As shown in Table 1, the deferral of tax liability under the installment method can substantially reduce a taxpayer's effective tax rate. For example, when interest rates are eight percent, the deferral of tax for ten years by a taxpayer with a marginal tax rate of 50 percent reduces the effective tax rate to 23 percent. In effect, under the installment method, the Federal government makes an interest-free loan to the taxpayer of the tax that otherwise would be due in the year of sale. The benefit of tax deferral under the installment method would be denied to taxpayers who have obtained cash by pledging an installment obligation.

In recent years many homebuilders have issued bonds secured by mortgage loans received upon the sale of houses. The use of so-called "builder bonds" has risen rapidly and is expected to exceed $5 billion in 1984. The proposal would somewhat reduce the tax benefits of such transactions. To the extent that the bond proceeds exceed the homebuilder's basis in the mortgage loans securing the bonds, the homebuilder would be treated as having received a payment on the

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mortgage loans. In such cases, the borrowing represents enjoyment of the profit element from the sale of the houses and should be taxed as income. Data concerning the extent to which similar transactions are used in other industries and by individual taxpayers is not available.

Table 1

Effective Tax Rate Per Dollar of Income Deferred by a
50 Percent Taxpayer
for Different Deferral Periods and Interest Rates

Interest rate	Deferral period (in years)					
	1	3	5	10	20	30
4 percent	48.1	44.4	41.1	33.8	22.8	15.4
6 percent	47.2	41.0	37.4	27.9	15.6	8.7
8 percent	46.3	39.7	34.0	23.2	10.7	5.0
10 percent	45.4	37.6	31.0	19.3	7.4	2.9
12 percent	44.6	35.6	28.4	16.1	5.2	1.7

Office of the Secretary of the Treasury
Office of Tax Analysis

November 25, 1984

LIMIT USE OF CASH METHOD OF ACCOUNTING

General Explanation

Chapter 10.03

Current Law

The Internal Revenue Code provides for the following permissible methods of accounting: (1) the cash receipts and disbursements method ("cash method"), (2) an accrual method, or (3) any other method or combination of methods permitted under Treasury regulations. A taxpayer is entitled to adopt any one of the permissible methods for each separate trade or business of the taxpayer, provided that the method selected clearly reflects the taxpayer's income from such trade or business. A method of accounting that reflects the consistent application of generally accepted accounting principles ordinarily is considered to clearly reflect income.

The cash method of accounting generally requires an item to be included in income when actually or constructively received and permits a deduction for an expense when paid. In contrast, the principles of the accrual method of accounting generally require that an item be included in income when all the events have occurred which fix the right to its receipt and its amount can be determined with reasonable accuracy. Similarly, a deduction is allowed to an accrual basis taxpayer when all events have occurred which determine the fact of liability for payment, the amount of the liability can be determined with reasonable accuracy, and the economic performance that establishes the liability has occurred.

In general, taxpayers (other than farmers) that are required to use inventories for a particular trade or business must use an accrual method of accounting for their purchases and sales. A taxpayer is required to use inventories in all cases in which the production, purchase, or sale of merchandise is an income-producing factor. Any other permissible method of accounting (including the cash method) may be used for other purposes in that trade or business or for other trades or businesses of the taxpayer.

A farmer generally may use the cash method of accounting even though the farmer is engaged in the production and sale of goods. Use of the accrual method is required, however, for a corporation engaged in the trade or business of farming (or a partnership engaged in the trade or business of farming that has a corporation as a partner) that has gross receipts of more than $1 million in any taxable year beginning after December 31, 1975.

Reason for Change

The cash method of accounting frequently fails to reflect the economic results of a taxpayer's business over a taxable year. The cash method simply reflects actual cash receipts and disbursements, which need not be related to economic income. Obligations to pay and rights to receive payment are disregarded under the cash method, even though they directly bear on whether the business has generated an economic profit or a loss. Because of its inadequacies, the cash method of accounting is not considered to be in accord with generally accepted accounting principles and, therefore, is not permissible for financial accounting purposes.

The relative simplicity of the cash method justifies its use for tax purposes by smaller, less sophisticated businesses, for which accrual accounting may be burdensome. Current law, however, permits many taxpayers that already use an accrual method for financial accounting purposes to use the cash method for tax purposes.

The cash method also produces a mismatching of income and deductions where the taxpayer engages in transactions with parties that employ a different method of accounting. For example, an accrual method taxpayer may deduct certain liabilities as incurred, such as liabilities for certain services rendered, even though the service provider on the cash method may defer reporting income until cash payment is made.

Proposal

In addition to the current law limitation on use of the cash method with respect to a trade or business in which inventory accounting is required, a taxpayer would not be permitted to use the cash method of accounting for a trade or business unless it satisfied both of the following conditions: (1) the business has average (determined on a 3-year moving average basis) annual gross receipts of $5 million or less (taking into account appropriate aggregation rules); and (2) no other method of accounting regularly has been used to ascertain the income, profit, or loss of the business for the purpose of reports or statements to shareholders, partners, or other proprietors, or to beneficiaries or for credit purposes.

Effective Date

The proposal would be effective for taxable years beginning on or after January 1, 1986. In order to minimize large distortions in the taxable income of taxpayers who are required to change from the cash to the accrual method, the administrative rules generally applicable to changes in methods of accounting initiated by the taxpayer and approved by the Internal Revenue Service would be applied. Accordingly, taxpayers affected by the proposal would be allowed to spread the adjustment that results from the difference between the use of the cash and accrual methods of accounting ratably over a period not to exceed six taxable years.

Analysis

The proposed restriction on the use of the cash method of accounting would affect only a small percentage of firms. In 1981, approximately eight percent of corporations, one percent of partnerships, and less than one percent of non-farm sole proprietorships, had receipts greater than the proposed $5 million limitation. Some of these businesses already use the accrual method of accounting for tax purposes. Accurate measurement of the income of these large firms is important to the integrity of the tax system, since they account for a significant share of business receipts.

The proposal would affect only businesses that are already using an accrual method of accounting in some part of their business or are sufficiently large to have professional accounting expertise. The primary industries that would be affected by the proposal would be banks that use an accrual method of accounting for financial reporting and large service organizations, such as accounting, law and advertising firms.

The virtue of the cash method's simplicity would be retained for those businesses that might be unduly burdened by a requirement that they use accrual accounting.

REPEAL RESERVE METHOD FOR BAD DEBT DEDUCTIONS

General Explanation

Chapter 10.04

Current Law

Taxpayers other than depository institutions may deduct a business bad debt in the year in which it becomes wholly or partially worthless. In lieu of deducting specific bad debts, a taxpayer may create a bad debt reserve for the obligations created or acquired in the course of a trade or business and held by the taxpayer at the close of the taxable year. In any year, the taxpayer may deduct an addition to the reserve sufficient to bring it to a reasonable level. The purpose of the reasonable reserve is to estimate the portion of the obligations held by the taxpayer at year-end that will become uncollectible in the future. Debts that become worthless during the year are charged against the reserve. This charge reduces the reserve and hence increases the amount that must be added to the reserve to restore it to an appropriate level. The deduction for additions to a bad debt reserve effectively allows a deduction for debts that become worthless during the year plus a deduction for future bad debts (attributable to the increase in the amount of receivables held at year-end.)

A dealer in property may deduct a reasonable addition to a reserve for bad debts relating to its liability as a guarantor of debt obligations arising out of the sale by the taxpayer of property in the ordinary course of its trade or business. In the case of certain taxpayers who were in existence in 1965, a suspense account arrangement prevents allowance of a double deduction by reason of a change in law which took place at that time.

Special rules govern the tax treatment of bad debts of depository institutions; these rules are dealt with in Chapter 12.01.

Reasons for Change

The reserve method for bad debt deductions of non-financial businesses allows taxpayers to deduct the bad debt losses in the current year and to deduct any net increase in the reserve. The deduction for the increase in the reserve represents a deduction for estimated future loan losses arising from an increase in the level of receivables on hand, without any discount for the present value of such losses. Moreover, the formula used to estimate such losses bears no necessary relationship to the future losses. The accelerated deduction for future losses defers taxable income and thereby reduces the effective tax rate of a business which experiences an increasing bad debt reserve.

In addition to distorting the timing of taxable income, the reserve method of accounting for bad debt deductions discriminates in favor of firms with growing accounts receivable or worsening loss experiences. In contrast, firms that have improved loss experiences or declining loan portfolios will be taxed on the deferred taxable income.

Finally, the preferential tax treatment of bad debt reserves reduces the effective tax rate on the compensation earned by lenders for bearing the risk of loan default and enables lenders to lower the risk premium charged. Thus, the tax system encourages lenders to make risky loans. By lowering the interest rate charged on risky loans, the preferential tax treatment also distorts the choice between debt and equity financing for projects involving some risk of default.

Proposal

The deduction for a reasonable addition to a reserve for bad debts would be repealed, although taxpayers would continue to be entitled to a deduction for debts that become worthless or are partially charged off. This proposal would also apply to the bad debts of financial institutions governed by Subchapter H.

Effective Date

The proposal would be effective for taxable years beginning on or after January 1, 1986. In order to prevent a double deduction for debts that become partially or wholly worthless after the effective date, a taxpayer's outstanding bad debt reserve at the close of the taxable year prior to the effective date would be includible in income ratably over a 10-year period.

Analysis

Taxpayers are generally not allowed to deduct future liabilities or losses until they occur. If reserves for future losses are allowed, a neutral tax reserve system would limit the deduction to the estimated present value of the future loss. Such a system would also require any divergences from the assumptions used in the present value calculation to be corrected. An accurate reserve system is not proposed because of the extreme administrative complexity that would follow.

To illustrate the deferral allowed by the current reserve system, suppose a new firm, shown in Table 1, begins with $1,000 of accounts receivable and in the first year has $10 of bad debts (an experience rate of one percent). Under a reserve system where the allowable reserve equals the current year losses, the firm establishes a year-end reserve of $10. The allowable first year bad debt deduction is $20 -- $10 of actual losses plus $10 for the increase in the allowable reserve. As long as the firm's loss experience does not improve and its level of receivables does not decrease, the excess deduction is deferred indefinitely. If the firm prospers and accounts receivable increase in year two to $1,500 with the same loss experience rate of one percent, the allowable reserve increases to $15 and the company deducts $20 -- $5 more than the actual loan losses. In year three, if loans remain the same but the loss experience worsens to two percent, the company can deduct $45. Finally, if in the fourth year the company experiences a decrease in accounts receivable, its bad debt deduction is less than the loan losses that actually occurred. A net decrease in the bad debt reserve effectively brings excess deductions back into taxable income, thereby ending tax deferral on that amount. Table 1 in Chapter 10.02 shows the reduction in effective tax rate due to tax deferral for given deferral periods and interest rates.

Table 2 shows the discrepency between bad debt deductions and actual loan losses due to the reserve method. The overstatement of losses and the amount of tax deferral depends on the growth rate of loans and the change in the loss experience rate. Credit growth over the past 10 years for domestic non-finiancial corporations was in excess of 20 percent annually. The change in the loss experience rate is not known, and is probably cyclical. Yet even with a constant loss rate, bad debt deductions overstated aggregate actual loan losses by 10 percent annually.

Table 1

Hypothetical Example of Excess Deductions with Reserve Method

	Year			
	1	2	3	4
Loss experience rate	1.0	1.0	2.0	2.0
Total loans	$1,000	$1,500	$1,500	$1,000
Actual losses	10	15	30	20
Beginning reserve	0	10	15	30
End reserve	10	15	30	20
Change in reserve	10	5	15	-10
Bad debt deduction [Losses plus change in reserve]	20	20	45	10
Excess deduction [Deduction minus actual losses]	10	5	15	-10
Accumulated excess deductions	10	15	30	20

Office of the Secretary of the Treasury
Office of Tax Analysis

November 29, 1984

Table 2

Discrepancy Between Reserve Deductions 1/ and Actual Bad Debt Losses By Change in Total Loans and Loss Experience
(In percent)

Annual Percentage Change in Loss Experience	Annual Percentage Change in Total Loans					
	-5	0	+5	+10	+15	+20
-5	-11.2	-4.9	-0.2	3.3	6.0	8.0
0	- 4.9	0	3.6	6.3	8.4	10.0
+ 5	- 0.2	3.6	6.4	8.6	10.2	11.4
+10	3.3	6.3	8.6	10.2	11.5	12.5
+15	6.0	8.4	10.2	11.5	12.5	13.3

Office of the Secretary of the Treasury
Office of Tax Analysis
November 29, 1984

1/ Assumes a six-year moving average experience method reserve. Shorter periods would increase the discrepancy.

CHAPTER 11

TAXATION OF ENERGY AND NATURAL RESOURCES

The tax law has long been used to subsidize the energy and mining industries. These subsidies lead to inefficiencies and misdirect investment capital. They would be eliminated under the Treasury Department proposals.

The business and residential energy credits would be repealed. Percentage depletion would be repealed, and indexed cost depletion made mandatory. Certain exploration and development costs that may be currently expensed would have to be capitalized as part of the cost of the property to which they relate. Preferential tax rates for certain royalty income would be denied, and the special deduction for mining and solid waste reclamation and closing costs would be repealed.

REPEAL ENERGY TAX CREDITS

General Explanation

Chapter 11.01

Current Law

A. Business Energy Tax Incentives

Special tax credits are available for business firms to encourage investments in conservation and renewable energy technologies and to encourage production of alternative fuels. These incentives can be grouped into three major categories:

1. **Energy Investment Tax Credits.** Solar, wind, geothermal property and ocean thermal property qualify for a 15 percent energy investment tax credit. Certain hydroelectric generating property qualifies for an 11 percent credit. Qualified intercity buses and biomass property are eligible for a ten percent energy credit. These energy credits terminate on December 31, 1985.

A ten percent energy investment tax credit was available for certain other types of energy property but this credit generally expired on December 31, 1982. However, if such energy property qualifies under "affirmative commitment" rules, the credit continues to be available until December 31, 1990. Under these rules, projects requiring two or more years for completion will continue to be eligible if (a) all engineering studies were completed and all necessary permits filed before January 1, 1983, (b) binding contracts for 50 percent of specially designed equipment are entered into before 1986, and (c) the project is completed and placed in service before 1991. In addition, in the case of hydroelectric generating property, the credit is available through December 31, 1988, if an application has been filed with the Federal Energy Regulatory Commission (FERC) before January 1, 1986.

2. **Production Tax Credits.** A credit of up to $3 per barrel of oil equivalent is available for certain qualifying fuels. In general, the credit is available for qualifying fuels produced from facilities placed in service after December 31, 1979, and before January 1, 1990, and sold after December 31, 1979, and before January 1, 2001. The credit phases out as the average wellhead price of domestic crude oil rises from $23.50 to $29.50 per barrel. The maximum credit and the phaseout range are adjusted for inflation. Qualifying fuels include (a) oil produced from shale and tar sands, (b) gas produced from geopressured brine, Devonian shale, coal seams, a tight formation, or biomass, (c) synthetic fuels produced from coal, (d) fuel from qualified processed wood, and (e) steam from solid agricultural byproducts.

3. **Alcohol Fuels Credit and Excise Tax Exemptions.**

a) **Alcohol fuels mixtures.** Present law provides a six cents per gallon exemption from the nine cents excise tax on gasoline and a similar six cents per gallon exemption from the 15 cents diesel fuel excise tax if the taxable products are blended in a mixture with at least ten percent alcohol ("gasohol"). The term alcohol is defined to include only alcohol derived from a source other than petroleum, natural gas, or coal (including lignite). The provision terminates after December 31, 1992.

b) **Alcohol fuels.** Present law provides a nine cents per gallon exemption from the excise tax on special motor fuels for a fuel consisting of at least 85 percent alcohol derived from a source other than petroleum or natural gas and a four and one-half cents per gallon exemption if the source is natural gas. The provision terminates after December 31, 1992.

c) **Alcohol production credit.** A 60 cents per gallon income tax credit is provided for alcohol used in gasohol mixtures with gasoline, diesel fuel, and special motor fuels. A like credit is allowed for alcohol used as a fuel other than in a qualified fuels mixture. A lesser credit of 45 cents per gallon is provided for alcohol of at least 150 proof but less than 190 proof. The term alcohol is defined to include only alcohol derived from a source other than petroleum, natural gas, or coal (including lignite). This credit terminates on December 31, 1992, and may be carried forward for 15 years, but not to a tax year beginning after December 31, 1994. If a production credit is claimed with respect to alcohol, the exemption from the gasoline and special fuels excise taxes is not allowed.

d) **Taxicabs refund.** A four cents per gallon exemption from the excise tax on gasoline, diesel fuel and special motor fuels is provided if used in certain taxicabs that are rated at above-average fuel economy. The exemption expires on September 30, 1985.

B. Residential Energy Tax Credits

Under current law there are two categories of residential energy tax credits:

1. **Conservation credits.** A 15 percent credit is available to individuals for the first $2,000 of expenditures for certain energy conservation equipment, such as insulation or storm windows and doors, for a maximum credit of $300.

2. **Renewable energy credits.** A 40 percent credit is available to individuals for the first $10,000 of expenditures for solar, wind or geothermal energy property, for a maximum credit of $4,000.

To be eligible for the residential energy tax credits, expenditures must be with respect to the taxpayer's principal residence. In the case of the residential conservation credits the residence must have been in use before April 20, 1978. The credits expire on December 31, 1985. Unused credits may be carried over through 1987.

Reasons for Change

Congress enacted the energy credits because oil and gas price controls understated the replacement cost of energy. Because of price controls, consumers did not have the incentive to invest in energy conservation and alternative fuels. The absence of free-market prices created an economic rationale for energy tax incentives. Since these incentives were enacted, however, crude oil prices have been decontrolled and natural gas prices are being decontrolled. As a result, these tax credits are no longer needed.

Proposal

The energy tax incentives would be allowed to expire or would be terminated on December 31, 1985.

Effective Dates

A. Business Energy Tax Incentives

1. **Renewable Energy Investment Tax Credits.** All renewable energy investment tax credits would be allowed to terminate on December 31, 1985. Unused credits may be carried forward or backward. However, for hydroelectric generating property the present law affirmative commitment rules will continue to apply.

2. **Energy Investment Tax Credits.** All conservation and other alternative source energy investment tax credits would terminate on December 31, 1985. However, present law affirmative commitment rules would continue to apply.

3. **Production Tax Credits.** All production tax credits would terminate on December 31, 1985. However, eligible fuel produced from a well drilled, or from facilities completed, before January 1, 1986, and sold before January 1, 1990, would continue to be eligible for the credit.

4. **Alcohol Fuels Credit and Excise Tax Exemptions.** The credit for alcohol fuels would be available for eligible alcohol fuels produced from facilities completed before January 1, 1986, and sold before January 1, 1993. All excise tax exemptions would terminate on December 31, 1985. The qualified taxicab refund that is scheduled to terminate on September 30, 1985, would not be renewed.

B. Residential Energy Tax Credits.

The residential energy tax credits would be allowed to expire on December 31, 1985, and would not be renewed. Carryovers of unused credits would continue to be available through 1987 as under current law.

Analysis

Because these energy incentives apply only to certain targeted activities, they introduce a tax differential among investments. Energy tax incentives distort the allocation of resources, encouraging individuals and firms to undertake investments that are uneconomical at current and expected future market prices. They also encourage users to purchase fuels that have a higher economic cost than alternative fuels because the tax system lowers the cost of the subsidized fuel. As a result, these incentives divert workers, capital and initiative from more productive uses elsewhere in the economy and lower the net productivity of our nation's capital stock.

These energy tax incentives also implement questionable energy policies. Subsidies provided for alternative fuels, for example, are significantly in excess of the price that should be paid for replacement of crude oil. With an alcohol fuel production credit at 60 cents per gallon, the Federal government is paying a subsidy of $25.20 (in addition to the price paid by the consumer) in order to save a barrel of oil currently valued at under $30.

The incentives effectively incorporate a Federal government spending program into the tax code. They also thereby add to the complexity of our tax laws and impose additional administrative burdens upon the Internal Revenue Service. A taxpayer compliance study with respect to individual income tax returns for taxable year 1979 disclosed that of $473 million of taxpayer claims for energy tax credits, $126 million in claims would have had to be disallowed had the Internal Revenue Service been able to fully audit all returns. Taxpayers failed to claim only $26 million in credits that they were otherwise entitled to claim. Thus, by Internal Revenue Service estimates, more than one-quarter of the amount of energy credits claimed by taxpayers for 1979 were invalid. The high error rate resulted from confusion over dollar limitations, qualification of equipment for credit, as well as improper carryovers. According to another study, in the case of the geothermal credit, nearly 95 percent of claimed credits were invalid because of an apparent massive misunderstanding of the applicable rules.

The residential energy credits, particularly the renewable energy credits, tend to favor middle- and upper/middle-income households, and cannot be justified on the ground that they are necessary to help low-income persons adjust to higher energy prices. For example, in 1982, households with adjusted gross income in excess of $30,000 accounted for about 60 percent of all renewable energy expenditures eligible for tax credits, but accounted for only 51 percent of total adjusted gross income.

Finally, many of the conservation improvements subsidized by the residential energy credits would have been made without the tax credits because of decontrol and the increase in world oil prices in 1979. Thus, in many cases, tax credits have served merely to reduce the encourage additional energy conservation efforts.

REPEAL PERCENTAGE DEPLETION

General Explanation

Chapter 11.02

Current Law

An initial difficulty in designing an appropriate method of capital recovery for the extractive industries arises from the fact that the quantity of reserves and the rate of production may be very different for different deposits. Moreover, production may be prolonged through the application of various enhanced recovery techniques. Thus, unlike depreciation methods which may be used to determine the recovery of investment in plant and equipment, a single economic life cannot be applied to investment in mineral properties.

Cost depletion resolves these difficulties by allowing a deduction each year equal to the product of the unrecovered costs and the ratio of the quantity of minerals sold during the year to the quantity of minerals estimated to be available as of the beginning of the year. By taking into account all the information obtained from the cumulative production record, cost depletion can provide a more appropriate allocation of the costs incurred to individual time periods than methods that rely on a fixed service life.

Percentage depletion, on the other hand, is a deduction in lieu of cost depletion based on a statutory percentage of the gross income from the property. The percentage of gross income that may be claimed is 15 percent for oil and gas, and ranges from 5 to 22 percent for other minerals. The allowance is limited to 50 percent of the net income from the property, and certain additional limitations apply in the case of oil and gas. Unlike all other cost recovery systems, a taxpayer may continue to claim percentage depletion after all the expenditures incurred to acquire or develop the property have been recovered.

Taxpayers with an economic interest in a mineral property must claim the greater of percentage depletion or cost depletion. Percentage depletion generally is not allowed in the case of oil and gas production. However, certain independent producers and royalty owners (i.e., taxpayers that do not refine or market more than specified quantities of product) are allowed to claim percentage depletion on production up to 1,000 barrels of crude oil equivalents per day. This quantity limitation must be allocated between different properties, and, at the taxpayer's election, between oil and gas production. In the case of coal and iron ore, corporate taxpayers must reduce such deductions by 15 percent of the amount in excess of the basis of the property. Taxpayers denied percentage depletion, as in the case of the integrated oil companies, may only use cost depletion.

The excess of percentage depletion over the adjusted basis of the property is a tax preference item for the corporate and minimum tax and the alternative minimum tax.

Reasons for Change

Since percentage depletion may continue to be claimed after all the taxpayer's costs have been recovered, percentage depletion is best viewed as a production subsidy, rather than as a method of capital recovery. As a production subsidy, however, percentage depletion is inefficient. Because of the relatively lengthy interval between the acquisition of a property and initial production (if, in fact, the property is ever productive) percentage depletion encourages excessive development of existing properties, rather than the exploration for new deposits. Moreover, because the allowance is limited to 50 percent of the net income from the property, tax benefits are cut back for developers of marginal properties. Instead, the greatest benefits are provided to the developers of the most prolific or highly concentrated deposits, which would most likely be developed even in the absence of these benefits.

Even if percentage depletion allowances were limited to capital invested, this method would not be an acceptable capital recovery method. Such a method would still provide faster capital recovery for owners of deposits that can be produced more rapidly (even if such production might represent a smaller fraction of total reserves) than for owners of less productive properties. Percentage depletion also would provide faster capital recovery when mineral prices rise, and less rapid recovery when prices fall. Since the discovery of a particularly prolific deposit or a change in product prices may be entirely fortuitous, a capital recovery allowance based on such factors is both capricious and inequitable. Tax simplification would also be enhanced if taxpayers did not have to determine the percentage depletion allowed and the associated tax preference.

Most importantly, cost depletion computed by reference to the taxpayer's adjusted basis in the property, indexed for inflation, is the equivalent of economic depreciation. Use of this method by the extractive industries would place them on a recovery allowance system similar to that employed by other industries.

Proposal

The percentage depletion allowance would be repealed for all minerals. Taxpayers would claim cost depletion on their adjusted basis in the property, if any, indexed for inflation.

Effective Date

The repeal of percentage depletion would be effective for production on or after January 1, 1986.

Analysis

Although the exact number of individuals claiming percentage depletion in excess of cost depletion is not known (even if it is assumed that percentage depletion is claimed by all 796,000 individual taxpayers reporting royalty income in 1981), half of the benefits would accrue to only 90,000 taxpayers with adjusted gross incomes of over $75,000. This amounts to an average benefit of approximately $6,400 for each of these taxpayers. Terminating this subsidy will increase the fairness of the tax system and permit tax rates for all upper-income individuals to be reduced.

REPEAL EXPENSING OF INTANGIBLE DRILLING COSTS

General Explanation

Chapter 11.03

Current Law

Intangible drilling costs (IDCs) are those costs of drilling and preparing oil, gas, and geothermal wells that are not incurred for the purchase of tangible property. These intangible costs include amounts paid for labor, fuel, repairs and site preparation necessary for the actual drilling. The cost of casings, valves, pipelines and other facilities required to control, transport or store the oil and gas produced are not included. Under current law, taxpayers have the right to elect to expense IDCs as incurred or to capitalize them. They may also elect to expense only the IDCs on dry wells and to capitalize the IDCs on productive wells. If capitalized, the costs are recovered through depletion or depreciation. IDCs are subject to recapture upon disposition of the property with respect to which they were deducted. Corporate taxpayers are allowed to expense only 80 percent of their IDCs; the balance must be capitalized and written off over 36 months. IDC deductions are an item of tax preference for the alternative minimum tax and the corporate minimum tax. No investment tax credit is allowed for IDC expenditures. However, non-corporate taxpayers owning other than a limited interest in oil and gas properties may elect to treat the IDCs as if they were investments in five-year ACRS property, and may claim an investment tax credit for such expenditures.

Reasons for Change

Intangible drilling costs represent a major portion of the costs necessary to locate and develop oil and gas reserves. Since the benefits obtained from these expenditures are of value throughout the life of the project, a proper matching of revenues and expenses requires that these costs be capitalized and recovered over the period of production.

The expensing of IDCs provides a tax benefit for capital invested in the oil and gas industry. Because investment in oil and gas is tax-favored, capital is diverted from other, more productive, economic activities. Further, even if an incentive for exploration is believed desirable, the expensing of IDCs is an inefficient incentive as it is equally available for developmental as well as exploratory drilling, and does not depend on or vary with the magnitude of the potential oil or gas reserves anticipated or discovered. In addition, since geological and geophysical costs incurred prior to the acquisition of a leasehold must be capitalized, allowing IDCs to be expensed also promotes an excessive reliance upon drilling, and an inadequate utilization of seismic and other more technologically advanced methods of exploration.

Proposal

The option to expense intangible drilling costs would be repealed, as would the 36-month amortization of 20 percent of IDCs for corporate taxpayers. These costs would be capitalized as depreciable or depletable property, depending upon the nature of the cost incurred. In conformity with the general rules for production cost accounting, as described in Chapter 10.01, depreciation incurred during the pre-production stage would be added to the cost of the depletable property, and these costs would be recovered through cost depletion. The depletable basis would be adjusted for inflation.

Effective Date

The repeal of the option to expense intangible drilling costs would be effective for costs paid or incurred on or after January 1, 1986.

Analysis

Based on the 1980 minimum tax data, it is estimated that in 1986, 31,000 individuals with adjusted gross incomes over $100,000 would receive over one-half of the total IDC tax benefits that go to individual taxpayers. These 31,000 taxpayers thus receive an average benefit of approximately $28,000.

Termination of these tax subsidies would increase the fairness of the tax system and permit reduction of the tax rates for high-income and other individuals. Repeal would also reduce the necessity of a minimum tax for individuals and corporations.

By allowing investors in oil and gas ventures to base their decisions on intrinsic economics, rather than on the tax benefits generated from their investments, the productivity of all investments would increase, even if a somewhat reduced percentage of investment capital is allocated to oil and gas production and more to other industries. The adverse effect which this proposal might otherwise have on the level of drilling activity would be partially offset by the reduction in corporate tax rates, the repeal of the windfall profit tax, and indexation of the depletable basis.

REPEAL EXPENSING OF HARD MINERAL EXPLORATION AND DEVELOPMENT COSTS

General Explanation

Chapter 11.04

Current Law

A taxpayer may elect to expense the exploration costs incurred to locate and delineate hard mineral deposits. After the existence of commercially marketable ores has been established, the development costs associated with the preparation of the mine for production also may be expensed. The exploration costs expensed (but not the development costs) must be recaptured, generally by claiming a reduced level of depletion deductions once the mine reaches the production stage. Corporate taxpayers can expense only 80 percent of the exploration and development costs. The remaining 20 percent of these costs must be capitalized and depreciated as five-year ACRS property, which qualifies for the investment tax credit. Mining exploration and development expenses are also items of tax preference under the alternative minimum tax.

Reasons for Change

The exploration and development costs incurred in locating and readying a mine for the production of hard minerals are similar to capitalized costs incurred in other industries. Since the benefits obtained are of value throughout the life of the mine, a proper matching of revenues and expenses requires that these costs be capitalized and recovered over the period of production.

Proposal

The option to expense hard mineral exploration and development costs would be repealed. These costs would be required to be capitalized, and the capitalized costs recovered through cost depletion deductions. The depletable basis of the mineral property would be adjusted for inflation. In determining the costs to be capitalized, the general rules for production cost accounting, which are described in Chapter 10.01, would apply.

Effective Date

Exploration costs paid or incurred on or after January 1, 1986 would be required to be capitalized.

Analysis

Because of the excess capacity which currently exists in the hard mineral industry, this proposal would have minimal impact on the level of mineral exploration and development for the next several years. The reduction in corporate tax rates will serve to offset any longer term impact of this proposal and the proposed repeal of percentage depletion on the extractive industries.

REPEAL DEDUCTION FOR QUALIFIED TERTIARY INJECTANT EXPENSES

General Explanation

Chapter 11.05

Current Law

Qualified tertiary injectant expenses may be deducted in the year paid or incurred. Qualified tertiary injectant expenses are the amounts paid for any tertiary injectant, other than a recoverable hydrocarbon injectant, that is used as part of an enhanced recovery process. The expenses are subject to the generally applicable recapture rules upon disposition of the property.

Reasons for Change

Tertiary injectant expenditures which yield enhanced production beyond the current year are similar to investments in other industries. Since the benefits obtained from these investments are of value throughout the life of the project, a proper matching of costs and expenses requires that these costs be capitalized and recovered over the life of the project. The allowance of an immediate deduction for these costs was intended to parallel the treatment given to intangible drilling costs. Since it is proposed that IDCs be capitalized, consistency (as well as fundamental tax accounting) requires capitalization of these costs as well.

Proposal

The deduction for qualified tertiary injectant costs would be repealed. Such costs would be required to be capitalized and recovered through cost depletion deductions. The depletable basis would be adjusted for inflation. The general rules for production cost accounting, which are described in Chapter 10.01, would apply. Waterflooding and similar pressure maintenance techniques, which enhance production for a period of less than one year, would continue to be expensed.

Effective Date

Qualified tertiary injectant expenses paid or incurred with respect to projects initiated on or after January 1, 1986 would be required to be capitalized. Prepaid costs would be deemed paid when economic performance occurs. Expansion of an existing tertiary recovery project would be regarded as the initiation of a new project.

Analysis

The proposal would make the choice of oil recovery processes depend upon sound engineering practices and economics, unaffected by Federal tax subsidies. The reduction in personal and corporate tax rates and repeal of the windfall profit tax would reduce the impact of this proposal on enhanced recovery projects.

REVISE ROYALTY TAXATION

General Explanation

Chapter 11.06

Current Law

Royalty income received by the owner of a royalty interest in coal or iron ore production qualifies for treatment as long-term capital gain. No percentage depletion allowance may be claimed with respect to such income. In order to receive capital gain treatment, the taxpayer must have been an owner of an interest in the coal or iron ore in place for at least six months, and must dispose of the ore under a contract by which he retains only a passive economic interest. In order to prevent operating owners from benefiting from these provisions, related party rules limit the availability of capital gain treatment.

Royalty income received by the owner of a royalty interest in timber qualifies for long-term capital gain treatment under rules similar to those applicable to coal and iron ore royalties. In addition, an owner of timber or a contract right to cut timber may elect to treat the cutting of timber (for sale or for use in the taxpayer's trade or business) as a sale or exchange of timber eligible for long-term capital gain treatment.

Reasons for Change

The special tax treatment of income from certain interests in timber, coal and iron ore is unjustified. Income from these natural resources should be subject to tax on the same basis as income from other investments.

Proposal

The provisions establishing special tax treatment for timber, coal and iron ore royalty income would be repealed, along with the provisions permitting elective sale or exchange treatment for owners of timber or contract rights to cut timber.

Effective Date

The repeal of capital gain treatment of timber, coal and iron ore royalty income would apply to all royalty income received on or after January 1, 1986. The repeal of the elective sale or exchange treatment for owners of timber or of contract rights to cut timber would apply to timber cut on or after January 1, 1986.

Analysis

The Treasury Department proposals would end preferential treatment for capital gains generally following a three-year transitional period for assets held prior to January 1, 1986. See Chapter 9.01. Owners of interests in timber, coal and iron ore would be eligible for capital gain treatment during the transition period only to the extent such treatment would be available without regard to the repeal of section 631.

REPEAL MINING AND SOLID WASTE RECLAMATION AND CLOSING COST DEDUCTION

General Explanation

Chapter 11.07

Current Law

Expenses that will be incurred in the future cannot generally be deducted currently, even if the existence of the liability can be established with certainty. As a general rule, taxpayers using the cash method of accounting may deduct future expenses only when payment is made. Taxpayers using the accrual method of accounting generally may deduct future expenses only when the economic performance or activity giving rise to the expense has occurred. However, pursuant to a statutory exception to the economic performance requirement, taxpayers may take current deductions associated with certain mining and solid waste disposal site reclamation and closing costs. The amount that may be deducted in any year generally is the estimated future reclamation or closing costs attributable to production or mining activity during the taxable year. The estimate must be made on the basis of reclamation and closing cost prices prevailing in the taxable year. To obtain the deduction, no amount need be placed into a fund, but deducted amounts are added to a bookkeeping reserve maintained for tax purposes. In addition, interest on the additions to the reserve must be added to the reserve each year at a rate specified in the statute. When reclamation or closing occurs, the balance in the reserve is compared to the actual cost of closing or reclamation. If the total amount in the reserve, including interest, exceeds the reclamation or closing costs, further deductions are not allowed and the excess must be included in income. Amounts spent on reclamation or closing costs are charged against the reserve, and only if the reserve is exhausted are the amounts deductible.

Expenses subject to the above rules include generally any expenses for land reclamation or closing activity pursuant to a reclamation plan under the Surface Mining Control and Reclamation Act of 1977 or similar law. Also included are expenses incurred for any land reclamation or closing activity in connection with any solid waste disposal site conducted in accordance with the Solid Waste Disposal Act or other similar law. Expenses attributable to property which is disturbed after being listed in the national contingency plan established under the Comprehensive Environmental, Compensation, and Liability Act of 1980 are not, however, included.

Reasons for Change

The special rules for strip mining and waste disposal closing and reclamation costs allow a current deduction for future costs without recognition of the fact that economic performance will occur, and the cost will be paid, in the future. The requirements to increase the reserve by an interest charge and to recapture reserves limit the extent to which the present value of the reserve is overstated. Nevertheless, the deduction generally is overstated in real terms and results in a reduced effective tax rate for those companies that find the special tax treatment to be advantageous for them.

The preferential tax treatment reduces the production costs of companies engaged in surface mining and companies generating solid waste. By reducing the costs of the products of these companies, the tax system encourages production processes that cause environmental damage. Regulations already in place require the environmental damage to be corrected. The tax system should not, however, subsidize the costs of compliance. Such costs generally should be borne (through higher product prices) by the users of the products whose production damages the environment, rather than by all taxpayers. If it is determined that certain of these costs are of such societal importance as to justify a Federal subsidy, that subsidy should be provided through the appropriations process, not the tax system.

The current reserve system is substantially more complicated than simply deducting the future expenses when they occur. Future expenses must be estimated; records must be kept of previously deducted amounts; interest must be imputed on this amount on a cumulative basis; and excess amounts in the account must be recaptured, requiring a re-estimate of future costs each year. Further, as reclamation or closing costs are incurred, the costs must be allocated to particular properties, since reclamation and closing can be taking place on several sites at the same time.

Proposal

The special rules for mining and solid waste disposal reclamation and closing costs would be repealed. Accordingly, such costs would generally be deductible only as the sites were closed or the land reclaimed.

Effective Date

The proposal would be effective for mining and solid waste disposal reclamation and closing costs incurred on or after January 1, 1986.

Analysis

The proposal would eliminate the indirect Federal subsidy for mining and solid waste reclamation and disposal costs. Under existing law, companies are allowed to accelerate deductions for future expenses, thus reducing their effective tax rates through tax deferral. This preferential tax treatment reduces the costs of companies incurring such expenses. The elimination of the tax preference can be expected to raise by a small amount the price of the affected products, which for the most part involve production processes that cause environmental damage. A small shift in consumption away from such products would result.

REPEAL WINDFALL PROFIT TAX

General Explanation

Chapter 11.08

Current Law

Under current law, an excise tax is imposed on crude oil produced domestically. Taxable crude oil is classified in three tiers. Generally, oil in tier one is oil that had been subject to price controls; oil in tier two consists of stripper well oil; and oil in tier three is newly discovered oil, tertiary oil and heavy oil. The base for the tax is the difference between a statutory base price (lower for tier one oil and progressively higher for tiers two and three), adjusted for inflation, and the amount for which the oil is sold, less a severance tax adjustment. The tax rate is 70 percent for tier one oil and descends to 60 percent for tier two oil and 30 percent for tertiary oil and heavy oil. The tax rate for newly discovered oil is 22-1/2 percent through 1987, 20 percent for 1988 and 15 percent for 1989 and thereafter. Independent oil producers are taxed at a 50 percent rate for tier one oil with respect to 1,000 barrels per day of production and are exempt from tax on stripper well oil. The tax is deductible for the purpose of the Federal income tax.

The windfall profit tax is scheduled to phase out over a 33-month period beginning in January 1991, or the first month after December 1987 in which cumulative net receipts exceed $227.3 billion, whichever occurs first.

Reasons for Change

The windfall profit tax was enacted in 1980 at a time when crude oil prices were greatly accelerating. The enactment of the tax was associated with the decontrol of crude oil prices. Since that time oil prices have significantly declined from their record high levels. Consequently, the perceived "windfall" for producers has generally dissipated. While windfall profit tax receipts have also declined significantly from projected levels, the windfall profit tax nevertheless reduces producer profits that might otherwise be reinvested in oil production or other productive activities.

In general, the Treasury Department proposals are designed to produce consistent rates of taxation on economic income and to eliminate tax-induced distortions in investment activity. Together with repeal of percentage depletion and expensing of intangible drilling costs, it is appropriate that the windfall profit tax be terminated.

Proposal

The windfall profit tax would be repealed.

Effective Date

The windfall profit tax would phase out over a 33-month period beginning with the month of January 1988.

Analysis

Gross receipts from the windfall profit tax for fiscal year 1983 were $12.2 billion while net receipts totaled $5.7 billion. It is anticipated that from the inception of the tax through fiscal year 1990, $53 billion in net tax receipts will have been collected. Since the price of oil is determined in the world market, producers are generally unable to pass the cost of the tax along to consumers.

Repeal of the windfall profit tax, together with the reduction in corporate and individual tax rates, would serve to offset the effects of the repeal of expensing of intangible drilling costs and of percentage depletion.

CHAPTER 12

FINANCIAL INSTITUTIONS

Part A. Commercial Banks and Thrift Institutions

This Part discusses proposals to conform special rules relating t the taxation of banks and thrift institutions to the general rules for the taxation of corporate income. The special bad debt reserve deduction for banks and thrift institutions would be repealed. Interest allocable to tax-exempt obligations held by banks, savings and loans, and certain other thrift institutions would be deductible. The tax exemption of credit unions and special reorganization rules for failing thrift institutions would be repealed.

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REPEAL SPECIAL RULES FOR BANK BAD DEBT DEDUCTIONS

General Explanation

Chapter 12.01

Current Law

Commercial banks and thrift institutions are generally subject to the corporate income tax, but receive preferred tax treatment that permits them to deduct additions to reserves for bad debts using a method unrelated to their actual loan loss experience.

Commercial banks may utilize either the percentage method or a modified version of the experience method for determining their bad debt deductions. The percentage method allows a current deduction for additions to reserves sufficient to maintain a reserve of up to 0.6 percent of eligible loans outstanding. The experience method for banks generally is based on average loan losses over the most recent six-year period. Banks need not be consistent in their choice of method from one taxable year to another. The provision permitting use of the percentage method is scheduled to expire at the end of 1987, at which time all commercial banks must use the experience method.

Thrift institutions may use modified versions of the percentage method or experience method available to banks. Alternatively, thrift institutions, if they hold sufficient amounts of their assets in certain eligible investments (primarily residential mortgages), may elect the percentage of taxable income method for purposes of establishing their bad debt reserves for qualifying real property loans. Savings and loan associations and stock savings banks must hold at least 82 percent of their total assets in eligible investments to receive the maximum deduction, which is equal to 40 percent of taxable income (computed with certain modifications). A lower percentage of taxable income is deductible if less than 82 percent of total assets constitute eligible investments. Mutual savings banks must hold at least 72 percent of their total assets in eligible investments to receive the maximum deduction, which is also subject to reduction if the percentage of eligible investments is less than 72 percent.

Thrift institutions that utilize the percentage of taxable income method are limited in the amounts of certain other tax benefits they may claim. For example, they may claim only one-half of the otherwise-allowable investment tax credit and their dividends-received deduction is reduced from that available to other corporations.

The corporate preference item reduction provisions reduce the amount of bad debt reserve deductions that a depository institution not on the experience method may claim. No deduction is allowed for an amount equal to 20 percent of the excess of a depository institution's addition to its bad debt reserves over the additions that would have been deductible had the institution used the experience method. In addition, an amount equal to 59-5/6 percent of such excess constitutes a tax preference item for purposes of the corporate minimum tax.

Reasons for Change

Current law provides more favorable tax treatment of bad debt losses to depository institutions than to lenders in other industries. This tax preference distorts the investment decisions of some depository institutions. A thrift institution may utilize the favorable percentage of taxable income method only if it specializes in residential mortgage lending. The maximum deduction is available only if 82 percent of the thrift's assets (72 percent for mutual savings banks) are invested in loans on residential real estate, liquid assets, or certain other assets. The linkage between a lower effective tax rate and residential mortage lending provides a disincentive to diversification by thrift institutions and thereby subjects thrifts to increased portfolio risk.

Finally, the special percentage of taxable income deduction benefits only profitable thrift institutions. Thrifts with no taxable income must elect the percentage of eligible loan method to maximize their net operating losses. Thus, the special bad debt deduction tied to residential mortgage lending benefits only a fraction of all mortgage lenders.

Proposal

The special rules for commercial banks and thrift institutions for computing additions to a bad debt reserve would be repealed. Depository institutions would be subject to the general rule applicable to all taxpayers. The Treasury Department proposals would require generally that bad debt losses be deducted only as they occur. See Chapter 10.04. This requirement would apply equally to commercial banks and thrift institutions.

Effective Date

The proposal would be effective for all taxable years beginning on or after January 1, 1986. Depository institutions would be required to include existing reserves in income over ten years, starting with the first taxable year beginning on or after January 1, 1986.

Analysis

Deductions for additions to reserves for bad debts are overstated for depository institutions compared to deductions for bad debts for other businesses. Because a bad debt reserve for tax purposes involves only bookkeeping entries with no set-aside of assets, the only practical effect of present law is to increase the after-tax income of depository institutions. The lower effective tax rate resulting from excess bad debt deductions subsidizes loans from depository institutions and enables them to offer loans at artificially low rates. The proposal would eliminate this subsidy.

The proposal would reduce the amount of bad debt deductions reported by depository institutions. Present law permits depository institutions to select from a variety of methods the one providing the largest deductions. For example, the percentage of eligible loan reserve method permits a bank to maintain a reserve equal to 0.6 percent of its outstanding loans without regard to actual loss experience. Thus, it only benefits banks with bad debt experience rates below that level; banks with higher bad debt rates will utilize the experience reserve method. In 1983, an estimated 73 percent of commercial banks found the percentage method to be more beneficial (actually, more used it because of special transition rules), while only 27 percent found the experience method to be more advantageous.

Excess deductions for additions to bad debt reserves by thrift institutions under the percentage of taxable income method reduce their effective marginal tax rates. Most thrift institutions were unable to take advantage of the percentage of taxable income method in 1981 and 1982 because they did not have taxable income. Only profitable thrift institutions derive any benefit from the percentage of taxable income method permitted under current law. For example, the total bad debt deductions claimed by savings and loan associations fell from $1.41 billion in 1979 to $0.14 billion in 1981, because the preferential tax treatment is tied to profits, not actual loan losses. In 1983, an estimated 60 percent of savings and loans found the percentage of taxable income method to be beneficial (actually, fewer did because of net operating loss carry forwards), while the remaining 40 percent found the percentage of outstanding loans method to be more beneficial.

Additional analysis of the proposed repeal of the reserve method for all bad debt deductions is provided in Chapter 10.04.

Ninety-seven percent of all savings and loan associations and 64 percent of all commercial banks had loss-to-loan ratios below the percentage method's allowable 0.6 percent. Also in 1983, 99 percent of all savings and loan associations and 58 percent of all commercial banks wrote off for financial reporting purposes less than 0.6 percent of their outstanding loans. The special bad debt reserve rules are clearly a large subsidy for most savings and loan associations and commercial banks and a significant distortion from the measurement of economic income.

DENY DEDUCTION FOR INTEREST TO CARRY TAX-EXEMPT BONDS

General Explanation

Chapter 12.02

Current Law

Current law generally denies a deduction to any taxpayer for interest on indebtedness incurred or continued to purchase or carry tax-exempt obligations. Whether indebtedness is incurred or continued to purchase or carry tax-exempt obligations is based on the taxpayer's purpose in incurring indebtedness while holding tax-exempt obligations, as indicated by the facts and circumstances of the particular case.

Until 1982, banks, thrifts, and certain other financial institutions could invest their depository funds in tax-exempt obligations without losing the deduction for interest paid on their deposits or short-term obligations. Under current law, however, such financial institutions are denied 20 percent of their interest deduction allocable to indebtedness (including deposits and other short-term obligations), incurred or continued in order to purchase or to carry tax-exempt obligations acquired after 1982. A statutory presumption treats a portion of a bank's or other financial institution's indebtedness as allocable to tax-exempt obligations in an amount equal to the ratio of (i) the average adjusted basis over the year of all tax-exempt obligations (acquired after 1982) held by the bank or financial institution to (ii) the average adjusted basis over the year of all assets held by the bank or financial institution.

The corporate mimimum tax generally does not apply to interest received by banks and financial institutions from the holding of tax-exempt obligations.

Reasons for Change

Basic measurement of income principles require that income be matched with the costs of its production. In line with these principles, the costs of producing tax-exempt income, including interest expense incurred to carry tax-exempt bonds, are properly nondeductible. Since the income to which such costs are attributable is exempt from tax, disallowance of a deduction is necessary to prevent the taxpayer from offsetting other nonexempt income.

The exception from the above principles for interest paid or incurred by commercial banks and thrifts has enabled these institutions to hold a substantial portion of their investment portfolios in tax-exempt obligations, substantially reducing their Federal tax liability. The full allowance of interest deductions to banks holding tax-exempt obligations contributes to the relatively low effective tax rates of banks. In 1981, prior to the changes reflected in current law, commercial banks paid only $926 million of Federal income tax on approximately $15 billion of net income.

In addition, the special rule for commercial banks and thrifts provides them with a competitive advantage over other financial institutions that are disallowed interest deductions for carrying tax-exempt obligations. Brokers and dealers currently are not allowed to deduct any portion of the interest paid to purchase or to carry tax-exempt securities. Similarly, life insurance companies must prorate their tax-exempt investment income between policyholders and the company, which is comparable to denying a deduction for interest incurred to carry tax-exempt obligations.

Proposal

Banks, thrifts and the other financial institutions favored under current law would be denied a deduction for 100 percent of their interest payments allocable to the purchase or carrying of tax-exempt obligations. The portion of a financial institution's interest payments that would be deemed allocable to the purchase or carrying of tax-exempt obligations would be the same as under current law. Thus, such portion would be equal to the ratio of (i) the average adjusted basis over the year of all tax-exempt obligations (acquired on or after January 1, 1986) held by the financial institution to (ii) the average adjusted basis over the year of all assets held by the financial institution. For example, if a bank holds $1,000,000 of tax-exempt bonds acquired after January 1, 1986, (measured by their average adjusted basis over the year) and $3,000,000 of other assets (similarly measured), its otherwise allowable interest deduction would be reduced by 25 percent without regard to whether paid to depositors, short-term obligors, or long-term obligors. The prorata presumption would be irrebuttable.

Effective Date

The proposal would be effective for interest allocable to tax-exempt obligations acquired on or after January 1, 1986. The current disallowance rule of 20 percent would continue to apply after December 31, 1985 to tax-exempt obligations acquired between January 1, 1983 and December 31, 1985.

Analysis

The deductibility of interest paid to purchase or to carry tax-exempt bonds increases the attractiveness of tax-exempt obligations because of the attendant opportunity to shelter other taxable income. Moreover, present law encourages banks to make investments that are not economically attractive except for the tax benefits. For example, a bank may borrow at a nine percent interest rate and invest in tax-exempt obligations yielding only seven percent interest. Economically, the bank would lose two percent on such a transaction; however, because the bank can deduct 80 percent of the interest paid, it pays an after-tax interest rate of only 5.7 percent

(9 x [1 - (.46 x .8)]) and makes an after-tax profit of 1.3 percent. Denying banks a deduction for interest allocable to the purchase or carrying of tax-exempt obligations would eliminate a tax incentive to make an otherwise unattractive economic investment.

Commercial banks hold one-third of outstanding tax-exempt securities and loans, as shown in Table 1. Commercial banks are the largest institutional investors, and are second only to households in total holdings of tax-exempt obligations. Commercial banks are the major institutional investors because of their ability to borrow funds and deduct interest to carry investments that earn tax-exempt income. The transitional rule would continue to allow banks to deduct interest attributable to bonds acquired prior to the effective date, so that there would be no incentive to sell existing holdings. Banks would continue to buy some tax-exempt bonds after the effective date as evidenced by the current holdings of life insurance companies and brokers and dealers, who are already subject to the proposed rule.

Viewed in isolation, this proposal would tend to reduce bank demand for tax-exempt bonds and exert upward pressure on tax-exempt interest rates, particularly short-term yields. Several of the Treasury Department proposals, however, would affect the interest rates of tax-exempt obligations. The aggregate impact on tax-exempt interest rates is uncertain because the elimination of non-governmental tax-exempt bonds, bonds issued for arbitrage purposes, and other tax shelters would tend to increase demand for the remaining governmental bonds and exert downward pressure on the interest costs paid by state and local governments.

Table 1

Distribution of Tax-Exempt Securities and Loans -- 1983

	Outstanding Tax-Exempt Bonds Amount (In Billions)	Percent
Households	$173.8	35.9
Nonfinancial Corporate Businesses	4.2	0.9
State and Local Government General Funds	9.7	2.0
Commercial Banks	162.4	33.5
Savings and Loan Associations	0.9	0.2
Mutual Savings Banks	2.2	0.4
Mutual Funds	31.5	6.4
Life Insurance Companies	10.0	2.1
State and Local Retirement Funds	1.8	0.4
Other Insurance Companies	86.7	17.9
Brokers and Dealers	1.4	0.3
Total	$484.6	100.0

Office of the Secretary of the Treasury
Office of Tax Analysis

November 30, 1984

Source: Board of Governors of the Federal Reserve System, Flow of Funds Accounts, Assets and Liabilities Outstanding, 1960-83

REPEAL TAX EXEMPTION FOR CREDIT UNIONS

General Explanation

Chapter 12.03

Current Law

Credit unions are exempt from tax on their income, whether such income is retained or distributed to depositors.

Reasons for Change

Because of their tax exemption, credit unions enjoy a competitive advantage over other financial institutions such as commercial banks and savings and loan associations. Their tax-exempt status has enabled credit unions to grow rapidly since 1951, when savings and loan associations and mutual savings banks became subject to the corporate income tax. Credit unions accounted for 5.7 percent of small time and savings deposits and 13.8 percent of consumer installment credit outstanding in 1983.

In an economy based on free market principles, the tax system should not provide a competitive advantage for particular commercial enterprises. Credit unions should thus be subject to tax on the same basis as other financial institutions.

Proposal

The tax exemption for credit unions would be repealed. Credit unions would be subject to tax under the same rules that apply to other thrift institutions.

Effective Date

The proposal would be effective for taxable years beginning on or after January 1, 1986.

Analysis

Tax exemption at the company level allows credit union customer/owners to defer tax liability on earnings retained by the credit union. By retaining their earnings tax-free, credit unions can offer their customer/owners higher rates of return than other financial institutions. Repealing the tax exemption of credit unions would eliminate the incentive for credit unions to retain, rather than distribute, current earnings.

The proposal will subject credit unions to tax on their retained earnings. To the extent that retained earnings are necessary for growth, credit unions will have to increase the spread between their "dividend" rates and loan rates to cover the Federal tax liability in the same manner as stock companies. As with other mutual depository institutions, however, credit unions could reduce the amount of Federal income tax paid at the corporate level by distributing more "dividends" to depositors or by providing lower loan rates to borrowers. Distributions of earnings would be included in taxable income currently at the individual level.

In 1983, Federal credit unions earned $4.0 billion in net income and distributed $3.6 billion in dividends or interest refunds to customer/owners. Retained earnings, which are tax-exempt and accrue tax-free interest income, were 10.6 percent of current net earnings. Some of the retained earnings would be distributed currently and taxed at the individual level; the remaining amounts would be subject to tax at the company level.

REPEAL REORGANIZATION RULES FOR FINANCIALLY TROUBLED THRIFT INSTITUTIONS

General Explanation

Chapter 12.04

Current Law

Certain acquisitions of the stock or assets of one corporation by another qualify as tax-free reorganizations under current law. In general, the shareholders of a corporation that is acquired in a reorganization may exchange their stock for stock of the acquiring corporation on a tax-free basis. In addition, a corporation acquired in a reorganization may exchange its assets on a tax-free basis for stock of the acquiring corporation.

Corporate acquisitions generally do not qualify as tax-free reorganizations unless they satisfy the "continuity of interest" requirement. Stated generally, an acquisition will satisfy the continuity of interest requirement only if the shareholders of the acquired corporation receive a significant, continuing equity interest in the acquiring corporation.

Special rules enacted in 1981 permit the acquisition of a "financially troubled" thrift institution to qualify as a tax-free reorganization without regard to the continuity of interest requirement. The continuity of interest requirement would generally pose an obstacle in such an acquisition because depositors are the only persons holding interests in the financially troubled thrift who would receive an interest in the acquiring corporation. Because of their insured position, however, the depositors in the failing thrift generally will not accept an equity interest in the acquiring corporation with its attendant risk of loss. For this reason, the acquiring corporation ordinarily will assume the failing thrift's liabilities to its depositors. In the absence of the special waiver, an interest as a depositor would not satisfy the continuity of interest requirement.

For the special rule to apply, the Federal Savings and Loan Insurance Corporation (FSLIC), Federal Home Loan Bank Board (FHLBB), or, where neither has supervisory authority, an equivalent State authority, must certify that the transferor thrift is insolvent, that it cannot meet its obligations currently, or that it will be unable to meet its obligations in the immediate future. In addition, the transferee must acquire substantially all of the transferor's assets and must assume substantially all of its liabilities. If an acquisition of a failing thrift institution satisfies these rules, the tax attributes of the failing thrift survive the acquisition and the acquiring corporation can use the net operating losses of the acquired thrift to lower its own taxable income.

In addition to the special reorganization rule, present law provides an exclusion from income for payments by the FSLIC to a thrift institution in connection with a reorganization. Such payments are not included in the thrift's gross income and do not reduce the thrift's basis in any of its assets.

Reasons for Change

The special rules governing reorganizations of financially troubled thrift institutions were enacted in 1981 to facilitate mergers and reorganizations of the then-ailing thrift industry. In such acquisitions, a profitable financial institution typically agrees to assume a failing thrift's obligations in consideration for payments from a regulatory body, such as the FSLIC, and the right to utilize the failing thrift's tax losses.

Thrift institutions and their shareholders should be subject to tax on the same basis as other business enterprises. The special rules for reorganizations of financially troubled thrift institutions depart from that objective, and effectively shift some of the burden of thrift losses to the Federal government. If such subsidization of reorganized financial institutions is necessary, it should be effected through direct appropriations. This would permit the appropriate regulatory agency to determine the need for and amount of a subsidy on a case-by-case basis.

Proposal

The special reorganization rules for acquisitions of financially troubled thrifts and the exclusion from income of FSLIC payments to thrift institutions in connection with a reorganization would be repealed.

Effective Date

The repeal of the special reorganization rules would be effective for acquisitions occurring on or after January 1, 1986. The repeal of the exclusion for certain FSLIC payments would apply to taxable years beginning on or after January 1, 1986.

Analysis

The Federal assistance provided through special tax rules hides the total subsidy cost and is likely to exceed the amount of assistance that would otherwise be provided through direct appropriations.

Part B. Life Insurance Companies and Products

The current Federal income tax treatment of life insurance companies and their products allows investors in such products to obtain a substantially higher after-tax return than is available on investments whose income is fully taxed on a current basis. The Treasury Department proposals would do away with this special treatment. Deferral on the income earned on the investment of life insurance premiums (other than term insurance) wuld be ended by taxing to the policyholder the annual increase in the cash surrender value of the policy. The same treatment would apply to annuity contracts. Policyholder loans and partial withdrawals would also be taxed to the policyholder, to the extent of any income credited to the policy but not previously taxed to the policyholder.

Special rules that reduce the income tax paid by life insurance companies would also be modified. The life insurance reserve for any contract would be limited to the contract's net surrender value. The special 20-percent life insurance deduction and 60-percent small life insurance company deduction would be repealed.

IMPOSE CURRENT TAXATION ON LIFE INSURANCE INSIDE INTEREST BUILD-UP

General Explanation

Chapter 12.05

Current Law

The premium paid on any life insurance policy (other than a term insurance policy) can be divided into three components: a pure insurance component, a loading component, and an investment or savings component. During any period, the pure insurance component of a policy serves to redistribute funds from policyholders who pay charges for insurance protection to beneficiaries of policyholders who die during the period. The loading component serves to cover the insurance company's expenses and to provide it with a measure of profit. The investment component of a policy arises from the fact that the company can invest funds paid by policyholders between the time the funds are received by the company and the time they are paid out to beneficiaries. The company in turn credits fixed or variable amounts in the nature of interest to the policy, thereby increasing the cash value of the policy and providing a return to the policyholder on his investment in the policy.

Thus, a policyholder who pays a premium in excess of the cost of insurance and loading charges for the year in which the premium is paid is, in effect, making a deposit into a savings account that earns interest for the benefit of the policyholder.

Current law permits life insurance policyholders to earn this income on amounts invested in the policy free of current tax. This untaxed investment income is commonly referred to as "inside interest build-up." The company issuing the policy is allowed a deduction for increases in its insurance reserves. Because the level of reserves relating to a policy increases as interest is credited to the policy, the reserve deduction effectively shields the investment income from tax at the company level.

If a policy fails at any time to satisfy a Federal tax statutory definition of life insurance, which requires that the contract have a significant insurance component, the policy is treated as a combination of term life insurance and an investment fund, with the income generated by the fund being currently taxable to the policyholder.

Any amount paid under a life insurance policy by reason of the death of the insured is excluded from the gross income of the beneficiary. Thus, if a policyholder holds a life insurance policy until his death, the investment income on the policy, which was not taxed when credited to the policy, escapes tax permanently. If a policyholder surrenders his life insurance policy before death in exchange for the policy's cash surrender value or receives distributions in the form of policyholder dividends, the policyholder recognizes ordinary income equal to the excess of the cash received over his net investment in the policy. The policyholder's investment in the policy includes the portion of his premiums that has been used to pay the cost of life insurance. Consequently, any investment income taxed to the policyholder is reduced by the cost of his life insurance, even though this cost is a personal expense of the policyholder and would not be deductible if paid directly.

Reasons for Change

The deregulation of financial institutions and various economic factors have resulted in an increase in the rate of interest paid on traditional investment products (e.g., bank accounts and whole life insurance policies) and a proliferation of competing investment vehicles offered by different types of financial institutions. The effect of these changes has been to increase the already substantial investment orientation of cash value life insurance products. Although the definition of life insurance places some broad limits on the use of life insurance as a tax-favored investment vehicle, it is still possible to design an insurance policy meeting this definition under which the cumulative investment earnings at currently prevailing interest rates are projected to be as much as eight times as large as the cumulative insurance costs. Thus, the favorable tax treatment of inside interest build-up on life insurance policies can be obtained through a contract that provides a relatively small amount of pure insurance coverage.

Interest income on comparable investment vehicles generally is not tax free or tax deferred. Instead, interest income credited on such investments generally is subject to tax whether or not the interest is currently received by the taxpayer. For example, taxpayers generally are subject to current tax on interest credited on certificates of deposit although the interest is not received until the certificate of deposit matures.

Moreover, life insurance is not subject to the significant limitations on the timing and amount of contributions, withdrawals, and loans that apply to other tax-favored investments, such as qualified pension plans and individual retirement accounts (IRAs).

The benefit of deferring or avoiding tax on the inside interest build-up on life insurance policies goes only to individuals with excess disposable income that enables them to save, and particularly to individuals in high tax brackets. This benefit is not available to lower income taxpayers and other individuals buying term insurance since it derives solely from the investment component of a policy (which is not present in a term insurance policy).

The tax-favored treatment of inside interest build-up encourages individuals to save through life insurance companies rather than other financial institutions and perhaps to purchase life insurance that they would not buy except to gain access to the favorable tax treatment of the investment income. This distorts the flow of savings and investment in the economy.

Proposal

Owners of life insurance policies would be treated as being in constructive receipt of the cash surrender value (taking into account any surrender charge or penalty) of their policies. Thus, a policyholder would include in interest income for a taxable year any increase during the taxable year in the amount by which the policy's cash surrender value exceeds the policyholder's investment in the contract. A policyholder's investment in the contract would be equal to the aggregate of his gross premiums, reduced by the aggregate policyholder dividends and other distributions under the policy and by the aggregate cost of renewable term insurance under the policy.

The investment component of a long-term life insurance contract would be eligible for any general savings incentive available to comparable investments. For example, the otherwise-taxable interest income produced by an increase in the cash surrender value of a life insurance contract during a taxable year could be designated as a contribution to an IRA.

Effective Date

The proposal would be effective for all inside interest build-up credited to policies sold on or after January 1, 1986. In the case of policies outstanding on December 31, 1985, inside interest build-up would continue to be free from tax until December 31, 1990. Beginning in 1991, this proposal would be phased in over a five-year period, so that future inside interest build-up on policies sold before January 1, 1986 would be fully subject to tax starting in 1995. Deferral of untaxed inside interest build-up would continue until withdrawal of funds from the policy. See Chapter 12.06. The policyholder's investment in the contract would not be reduced by the cost of term insurance for any period prior to January 1, 1986.

Analysis

Taxing the inside interest build-up on life insurance policies would eliminate the largest tax distortion in the financial services area and would place competing financial products and institutions on more equal footing. This would promote the efficient flow of long-term savings.

Current taxation of inside interest build-up also would eliminate the need for complex rules and restrictions in several areas, including the determination of tax liability when a policy matures or is surrendered and the definition of contracts that qualify as life insurance. For a discussion of how this proposal would affect the treatment of policyholder loans, see Chapter 12.06.

Table 1 shows the distribution of cash value life insurance policies by family economic income. High-income families are more likely to have cash value policies as well as larger policies. The average annual tax-deferred interest income earned on life insurance and annuity policies in 1983 is estimated at $3,050 for families with income greater than $200,000 and less than $200 for families with income less than $30,000. Because the purchase of life insurance policies for predominantly investment purposes is a recent development, the difference between the amount of inside interest build-up earned by wealthier individuals and that earned by less wealthy individuals is expected to grow in the future.

Table 1

Distribution of Ownership of Cash-Value Life Insurance Policies and the Annual Inside Interest Build-up 1/
By Economic Income - 1983

Family Economic Income	Families with Cash-Value Life Insurance Policies Percentage	Average Annual Inside Build-up 2/
$ 0 - 9,999	13	$ 85
10,000 - 14,999	25	110
15,000 - 19,999	33	135
20,000 - 29,999	41	190
30,000 - 49,999	53	310
50,000 - 99,999	68	520
100,000 - 199,999	78	1,240
200,000 or more	70	3,050
All Families	42	$ 355

Office of the Secretary of the Treasury
Office of Tax Analysis

November 29, 1984

1/ Includes annuities.
2/ For those with policies.

Source: Treasury estimates.

It is anticipated that many low- and middle-income individuals who currently own relatively small amounts of cash value life insurance and who would not otherwise maintain IRAs will designate their existing policies as IRAs. If the annual premium (net of policyholder dividends) plus the inside interest build-up on the policy does not exceed the applicable IRA limit, the inside interest build-up would continue, in effect, to be free from current tax. However, the rules respecting the timing of distributions from IRAs would apply and any cash value held in a life insurance IRA at the policyholder's death would be taxed to the beneficiary like any other IRA distribution. (The excess of the death proceeds over the cash value would be exempt from tax, as under current law.)

REVISE TAXATION OF POLICYHOLDER LOANS AND PARTIAL WITHDRAWALS

General Explanation

Chapter 12.06

Current Law

Life insurance policies normally permit the policyholder to borrow funds from the life insurance company in an amount up to the cash value of the policy. Until repaid, the amount of a policyholder loan reduces the proceeds payable to the policyholder in the event of a surrender of the policy or to the beneficiaries in the event of the death of the policyholder.

Policyholder loans are respected as loans and are not treated as withdrawals from the policy, even if the loans are not repaid prior to the death of the insured. Moreover, subject to certain restrictions, interest paid on policyholder loans is deductible by the policyholder even though the policy's inside interest build-up is not subject to current tax.

Generally, if a policyholder withdraws cash from his policy, he is treated as recovering first his investment in the policy. Only after the entire investment has been recovered is the excess amount withdrawn subject to tax. However, a special rule in the definition of life insurance provides that if cash is withdrawn from a policy as a result of a reduction of future death benefits under the policy, the cash will be treated as "boot" in an exchange transaction and subject to tax.

Reasons for Change

Because the inside interest build-up on life insurance policies is not taxed until withdrawal, and is not taxed at all if the policy is held until death, interest deductions from policyholder loans can be used to shelter other taxable income. Currently, life insurance companies are able to market policies with fixed borrowing schedules that provide substantial tax advantages to the policyholder. Under some of these plans, the tax advantages are so large that they have been marketed primarily as tax shelters and only incidentally as life insurance.

Through a partial withdrawal of the cash surrender value from a life insurance policy, a policyholder may receive back an amount that does not exceed his investment in the policy free from tax. A policyholder should not be allowed to cash in his investment while continuing to defer the payment of tax on income from that investment.

Borrowing against the cash value of a life insurance policy reduces the total amount invested by the individual in the policy and has the effect of a partial withdrawal of the policy's cash surrender value. These economically equivalent transactions should be accorded equivalent tax treatment.

Although current taxation of inside interest build-up is proposed in Chapter 12.05, the transitional rule under that proposal would permit the continued deferral of tax on certain inside interest build-up for policies outstanding on December 31, 1985. Accordingly, even if the proposal in Chapter 12.05 is adopted, a revision of the policyholder loan and partial withdrawal rules is needed as a temporary measure.

Proposal

Policyholder loans and partial withdrawals under a policy (not including policyholder dividends and similar distributions), to the extent of any income credited to the policy but not yet included in the taxable income of the policyholder, would be treated as a distribution of such income to the policyholder. The amount of income treated as distributed to the policyholder would be limited to the excess of the cash surrender value of the policy (taking into account any surrender charge or penalty) over the policyholder's investment in the contract. The policyholder's investment in the contract would equal the aggregate amount of premiums paid for the contract reduced by the sum of the aggregate amount of policyholder dividends and similar distributions and the aggregate cost of insurance, taking into account only the cost of insurance after December 31, 1985.

Effective Date

The proposal would apply to policyholder loans and partial withdrawals made on or after January 1, 1986. In addition, all policyholder loans outstanding on December 31, 1985, to the extent not repaid before January 1, 1991, would be treated as new loans to which the proposal applies.

Analysis

The treatment of policyholder loans and partial withdrawals as distributions coming first out of any untaxed investment income under the policy ensures that the tax deferral of inside interest build-up occurring prior to the effective date of these proposals will continue only as long as savings and investment income are retained in the policy. The treatment of outstanding loans not repaid before January 1, 1991 as new loans subject to the proposal would reduce an otherwise strong incentive for policyholders to withdraw funds through policyholder loans shortly before the effective date of the proposal.

The need for this rule (and for the provisions of current law prescribing special treatment of policyholder loans) will disappear after all policies containing untaxed inside interest build-up mature or are surrendered. However, if the proposal in Chapter 12.05 to tax currently the inside interest build-up on life insurance policies is not adopted, this proposal would be needed as a permanent rule.

IMPOSE CURRENT TAXATION ON DEFERRED ANNUITY INVESTMENT INCOME

General Explanation

Chapter 12.07

Current Law

Income credited to a deferred annuity contract is not taxed currently to the owner of the contract or to the insurance company issuing the contract. In general, amounts received by the owner of an annuity contract before the annuity starting date (including loans under the contract) are taxed as ordinary income to the extent that the cash value of the contract exceeds the owner's investment in the contract. A portion of each distribution received after the annuity starting date is taxed as ordinary income based on the ratio of the investment in the contract to the total distributions expected to be received. Penalties are imposed on certain premature distributions under an annuity contract.

Reasons for Change

Investment income earned on deferred annuities is similar to investment income earned on other savings instruments with other financial institutions. Interest on savings accounts and certificates of deposits is taxed currently, however, while investment income earned on annuities is not taxed until withdrawal. Moreover, deferred annuities are not subject to the significant limitations on the timing and amount of investments that apply to other tax-favored investments, such as pension plans and individual retirement accounts (IRAs). Yet deferred annuity savings are more likely than other tax-favored investments to be withdrawn before retirement because of the smaller withdrawal penalty.

Since tax-favored annuities can be purchased only from life insurance companies, this tax deferral directs the flow of savings toward life insurance companies and away from other financial institutions. There is no reason to favor savings through insurance companies over savings through competing financial institutions.

The deferral of tax on investment income credited to deferred annuities is available only to persons with disposable income available for savings and is of greatest benefit to persons in the highest tax brackets. The tax deferral thus favors wealthier individuals.

Proposal

Owners of deferred annuity contracts would be treated as being in constructive receipt of the cash value (taking into account any surrender charge or penalty) of their contracts. Thus, the owner would include in interest income for a taxable year any increase during the taxable year in the amount by which the contract's cash value exceeds the owner's investment in the contract.

A deferred annuity contract would be eligible for any general savings incentive available to comparable investments. For example, the otherwise-taxable interest income produced by an increase in the cash surrender value of a deferred annuity contract during a taxable year could be designated as a contribution to an IRA.

Effective Date

The proposal would be effective for all investment income credited to contracts sold on or after Jauary 1, 1986. In the case of contracts outstanding on December 31, 1985, investment income credited to the contracts would continue to be untaxed until December 31, 1990. Beginning in 1991, this proposal would be phased in over a five-year period, so that future income credited to contracts outstanding on December 31, 1985 would be fully subject to tax starting in 1995. Deferral of untaxed investment income credited to a contract would continue until withdrawal or distribution of funds from the policy. The penalty imposed on premature distributions under a deferred annuity contract would be repealed for distributions on or after January 1, 1986. All of the other provisions prescribing special treatment of distributions under annuity contracts before the annuity starting date would become obsolete as annuities containing untaxed investment income are surrendered or mature.

Analysis

Taxing the investment income credited to deferred annuity contracts would eliminate a major distortion in the financial services area and would place competing financial products and institutions on more equal footing. This would permit the efficient flow of long-term savings.

Since life insurance companies selling deferred annuities are accustomed to designing investment vehicles to provide for policyholders' retirement, it can be anticipated that companies currently selling deferred annuities will be able to compete effectively for IRA investments. For example, life annuities sold by life insurance companies are the only financial instrument to insure against living beyond one's wealth after retirement. An IRA maintained with a life insurance company may be attractive to investors since a life annuity is available as a direct settlement option, avoiding the need for a rollover from an IRA maintained with another financial institution into a separate annuity IRA upon retirement.

LIMIT LIFE INSURANCE COMPANY RESERVE DEDUCTION

General Explanation

Chapter 12.08

Current Law

The gross amount of premiums received by a life insurance company is included in the taxable income of the company. As described in Chapter 12.05, the premium paid on any life insurance policy (other than a term insurance policy) can be divided into a loading component, a term insurance component, and a savings component. The savings component of a premium is held, in effect, for the benefit of the policyholder in an interest-bearing account. The savings component is needed to help fund the higher cost of insurance protection in later years and is currently available to the policyholder in the form of the policy's cash surrender value.

Life insurance companies are allowed a deduction from taxable income for any net increase in life insurance and other reserves and must include in income any net decrease in reserves. The life insurance reserve for any contract is the greater of the net cash value of the contract (taking into account any surrender penalty or charge) or the reserve for policy claims determined under a prescribed set of rules (based on prevailing State regulatory requirements) relating to the reserve method, assumed interest rate, and assumed mortality or morbidity rate. These latter rules attempt to measure the amount needed to fund the anticipated excess of the present value of future claims and benefits to be paid under the policy over the present value of future premiums (if any) to be received under the policy. The reserve deduction thus serves to adjust the company's income to account for its liability to pay, in the event of a surrender of the policy, the cash value or, in the event of a claim under the policy, the face amount of the policy.

Reasons for Change

Like the receipt of savings deposits by a bank, the receipt of the savings component of life insurance premiums should not be taxed to the company. However, the remaining portions of the gross premiums -- the loading component and the term insurance component -- should be taxed to the company, with corresponding deductions for sales and administrative costs and the payment of claims. Thus, if gross premiums are included in the gross income of the company, an offsetting deduction for the savings component of the premiums is appropriate.

The allowance of a reserve deduction for the increase during the taxable year in the greater of the policy's cash surrender value or the reserve for policy claims often will overstate the company's reserve deduction, especially in the initial years of the policy. This is because the reserve for policy claims, i.e., the estimate of the excess of the present value of future claims and benefits over the present value of future premiums, is calculated using conservative assumptions required for State regulatory purposes.

A reserve deduction equal to the increase in the cash surrender value of a policy generally would be sufficient to exclude the savings component of gross premiums from the company's taxable income and allow a deduction for the exact amount of interest credited to the policyholder's savings account. Moreover, the policy's cash surrender value is an objective measure of the reserve for policy claims needed by the company. This is because the cash surrender value is, in effect, the amount the company is willing to give to the policyholder if he gives up his right to claims and benefits under the policy.

The initial overstatement of reserves allowed under current law results in tax deferral and a reduced effective tax rate for life insurance companies. This enables life insurance companies to offer policyholders higher rates of return on savings or lower costs of insurance, thereby attracting investment dollars from other financial institutions.

Proposal

For tax purposes, the life insurance reserves for any contract would be limited to the net cash surrender value of the contract (taking into account any surrender penalty or charge). The reserve deduction would be adjusted to reflect the indexing of interest. See Chapter 9.03.

Effective Date

The proposal would be effective for policies sold on or after January 1, 1986.

Analysis

Restricting life insurance companies' deductions for additions to reserves to the increase in the cash surrender value of policies issued by the company would be consistent with the separation of income and liabilities of other financial institutions. The actual amount of the savings deposits included in life insurance premiums effectively would be excluded from taxable income. Similarly, the actual amount of interest credited to policyholders would be deducted by the company and, as proposed in Chapter 12.05, included in the income of the policyholders. This would eliminate the different tax treatment of savings at the company level between life insurance companies and depository institutions.

Life insurance companies would increase their premiums (or earn lower profits) as a result of any increased tax liability resulting from the more accurate measurement of their taxable income.

REPEAL SPECIAL LIFE INSURANCE COMPANY DEDUCTIONS

General Explanation

Chapter 12.09

Current Law

All life insurance companies are allowed a deduction equal to 20 percent of their otherwise taxable income. In addition, a small life insurance company is allowed a deduction equal to 60 percent of the first $3 million of its otherwise taxable income. This deduction phases out as otherwise taxable income increases from $3 million to $15 million. The small company deduction is allowed only to companies with gross assets of less than $500 million. Consolidated group tests generally are used in applying the taxable income and gross asset standards.

Reasons for Change

The special deduction for all life insurance companies was enacted to reduce the competitive impact of the Tax Reform Act of 1984, which broadened the tax base of life insurance companies without similarly broadening the tax base for competing financial institutions. Enactment of comprehensive tax reform that affects all financial institutions and reduces the maximum marginal tax rate would eliminate the justification for the special deduction for life insurance companies. Retention of the special deduction for life insurance companies would be unfair to their competitors and would cause tax-induced economic distortions.

Similarly, the special deduction for small life insurance companies was a deviation from the proper measurement of economic income to prevent a dramatic increase in the tax burden of small life insurance companies as a result of the 1984 Act. After comprehensive tax reform, special rules for small life insurance companies would no longer be appropriate.

Proposal

The special life insurance company deduction and small life insurance company deduction would be repealed.

Effective Date

The proposal would be effective for taxable years beginning on or after January 1, 1986.

Analysis

The revision of the tax rules governing life insurance companies in 1984 essentially broadened their tax bases and reduced their effective marginal tax rates. Repeal of the special 20 percent deduction provision would be more than offset by the reduction in the maximum corporate tax rate. The 20 percent deduction of otherwise taxable income lowers life insurance companies' effective marginal tax rate to 36.8 percent. The Treasury Department proposals would lower the corporate rate to 33 percent.

Small life insurance companies would be placed on a par with all other life insurance companies and other small corporations. Elimination of preferential tax rates based on the size of the firm would end tax-induced distortions that favor sales of life insurance through small firms.

Part C. Property and Casualty Insurance Companies

This Part discusses proposals to curtail favorable tax rules for property and casualty (P&C) insurance companies. The deduction for estimated unpaid losses, which is currently allowed on an undiscounted basis, would be allowed only to the extent of the discounted present value of the losses. Special provisions that reduce the effective tax rate on P&C insurance companies would be eliminated. Thus, the deduction for contributions to a protection against loss account would be repealed. The deduction for policyholder dividends by mutual P&C companies would be repealed. The deduction for policyholder dividends by mutual P&C companies would be limited in conformity with the deduction allowed mutual life insurance companies.

LIMIT PROPERTY AND CASUALTY INSURANCE COMPANY RESERVE DEDUCTION

General Explanation

Chapter 12.10

Current Law

Property and casualty ("P&C") insurance companies are allowed a deduction for "losses incurred" during a taxable year. The deduction includes the company's estimate of "unpaid losses," whether or not unpaid losses have accrued under traditional tax accounting rules. Unpaid losses include amounts that will be paid in connection with claims filed with the company during the taxable year as well as amounts that relate to claims expected to arise from events occurring during the taxable year that have not been reported to the company. The deduction for these claims generally is not discounted to reflect the fact that they will not be paid until some time in the future.

Reasons for Change

The deduction of additions to reserves, unadjusted for the investment income that will be earned on those reserves, results in deferral of P&C companies' tax liability and reduces their effective tax rates. In other cases where tax deductions for additions to reserves are allowed, such as for life insurance companies, the allowable reserves are discounted for the expected future investment earnings on the reserve funds. The reserve deduction available to P&C companies should also be discounted.

The current tax treatment of P&C insurance reserves distorts the choice between self-insurance and third-party insurance. P&C companies deduct currently the full amount of the future liability for many casualty losses that would not be deductible currently by the self-insurer. Because a current tax deduction is more valuable than a future deduction, individuals and businesses are encouraged to insure against risks with a P&C company in order to take advantage of this favorable tax treatment.

Proposal

The deduction by P&C companies for unpaid losses during a taxable year would be computed under the "qualified reserve account" method. Under this method, the company would establish reserve accounts for claims to be paid in an amount estimated by the company to be sufficient to fund payment of the claims, taking into account the company's estimates of the amount of the claims, the time of payment of the claims, and the company's after-tax rate of return on its investment assets. Separate reserve accounts would be established by line of business and year of policy issuance. In other words, one account would be established for all claims under all policies in a particular line of business issued in a particular taxable year.

The initial reserve with respect to a policy could not exceed the premiums received under the policy reduced by the share of the company's deductible sales and administrative expenses allocated to the policy. Beyond this, the company would not be subject to federally prescribed rules for discounting future losses in establishing the reserve account. Instead, the company would be free to use any reasonable discounting method (e.g., the same estimates it used in pricing its insurance policies).

Each reserve established by the company would be increased annually by a percentage equal to the after-tax rate of return actually earned by the company on its investments during that year. To prevent the company's investment income from being sheltered from tax, no additional reserve deduction would be allowed for the annual increase in the reserve accounts attributable to the allocation of investment income.

The company would be allowed a deduction each year for the full amount paid to satisfy claims, but would be required to include in taxable income an offsetting amount released from the appropriate reserve account. This would ensure that, if the company's estimates of the amount and timing of claims and after-tax rate of return on investment assets were accurate, the reserve would be exhausted and the last claim would be paid simultaneously. If the reserve was insufficient to cover all claims, the excess claims would be deductible when paid. Conversely, if any amount remained in a reserve account after payment of the last claim in that account, that amount would be included in taxable income.

A company would be permitted to strengthen a reserve it felt was insufficient to cover future claims and a deduction would be given for additional amounts placed into a reserve. However, the company would be required to establish the need for reserve strengthening by a showing of objective factors affecting the amount needed to fund the payment of claims. Such factors would include a strengthening of the company's reserves on its annual statement or a decline in prevailing interest rates. Companies also would be free to release into income additional amounts from reserves it felt to be excessive. This would allow companies to avoid or reduce a large income item in a single year from the release of an excessive reserve.

A company would not be able to maintain a reserve indefinitely. Rules would be established limiting the maximum life of a reserve, depending on the line of business. Any reserve balance at the end of the maximum life would be released into income. Any subsequent claims under policies covered by that reserve would be deductible when paid.

Effective Date

The proposal would be effective for all unpaid losses with respect to all policies issued on or after January 1, 1986.

Analysis

Under the proposal, P&C companies would still be permitted to use the reserve method to match income and losses occurring in different taxable years. The discounting of losses, however, would prevent the reserve deduction from yielding greater tax benefits than a deduction claimed at the time the losses are paid or accrued. Discounting the amount of allowable reserves for tax purposes would take into account the time value of money. A current deduction of $1,000 is worth considerably more than a future deduction of $1,000 because investment income will be earned on the tax saving. For the same reasons, less than $1,000 needs to be held in reserve to fund a future liability of $1,000. For example, if interest income accumulates at an after-tax rate of six percent, a reserve of only $792.09 is needed to provide sufficient funds to satisfy a liability four years in the future of $1,000.

A substantial portion of the claims paid by P&C companies are paid in years subsequent to the year in which premium income is received and a deduction for losses paid or incurred is claimed. Table 1 shows the average period of loss payment for all insurance written by P&C companies and for several major lines of business. As shown on the table, over 60 percent of all losses of P&C companies are paid after the year of deduction. The actual discounted value of these losses at the time the premium income is received, assuming a six percent discount rate, is approximately 91 percent of their undiscounted value. In the case of medical malpractice insurance, a line of business where long delays in the payment of claims are common, more than one-half of all losses are paid beyond the fourth year after the year of deduction and the discounted value of the losses at the time the premium is received is only approximately 76 percent of their undiscounted value.

It has been argued by some that the present system of undiscounted claims reserves results in "rough justice" since it allows a deduction to some taxpayer in the full amount of an economic loss (of either the policyholder or a third party to whom the policyholder is liable) when the loss is incurred. Arguably, it is proper to match the time of the P&C company's deduction to the time the underlying economic loss is sustained. However, except in the case of business losses, a large portion of property and casualty liabilities would not be deductible losses to the party suffering the underlying economic loss. For instance, individual taxpayers can claim a casualty loss deduction on personal property only for the amount of loss in excess of ten percent of the individual's adjusted gross income. Deductions for medical expenses are limited to those in excess of five percent of adjusted gross income. In the case of medical malpractice and workers'

Table 1

Timing of Loss Payments to Total Losses Incurred
by Major Lines of Business of Property and Casualty
Insurance Companies - 1975 to 1983 Experience

Time Between Loss Incurred and Payment	Payments as Percent of Losses Incurred					
	Line of Business					
	All Business	Auto Liability	Other Liability	Medical Malpractice	Workers' Compensation	Multiple Peril
Same year	36.7%	36.0%	12.1%	5.8%	27.4%	56.2%
1 year	26.1	29.7	15.6	8.6	24.8	26.2
2 years	10.5	14.4	11.4	9.0	12.7	5.1
3 years	8.3	9.0	13.1	12.1	8.8	4.5
4 years	4.6	4.5	9.9	10.3	4.9	2.3
5 years	3.2	2.6	8.3	10.6	3.6	1.4
6 years	2.4	1.2	7.0	8.1	2.9	1.3
7 years	1.4	0.9	6.5	3.3	1.4	0.7
8 years or later	6.7	1.8	16.2	32.1	13.7	1.6
Present value loss of $100 incurred. 1/	$90.56	$92.40	$81.34	$76.28	$87.48	$95.13

Office of the Secretary of the Treasury
Office of Tax Analysis

November 29, 1984

1/ Discounted by the payment stream at six percent. Assumes payments are made in the middle of the year and discounted to the middle of the first year. The present value is overstated because many of the payments eight years or later are not fully discounted, which would particularly affect medical malpractice, other liabilities, and workers' compensation.

compensation liabilities, payments on contested or uncertain liabilities generally are not deductible by the policyholder until payment is actually made nor is the "economic" loss to the injured party generally a deductible expense to such party.

It has also been argued that it is inappropriate to mandate the discounting of reserves for Federal tax purposes because P&C companies are generally underreserved (as a result of underestimating future claims). Under current law, however, even a company that has established an initial reserve equal to (or even less than) the present value of a future claim derives a significant benefit. For example, if a P&C company establishes a reserve of $792.09 for a future claim that it estimates will be $792.09, and if the claim turns out to be $1,000, the company will receive an additional deduction of $207.91 when the claim is paid, even though it received a full deduction (in present value terms) when the reserve was established.

The discounting of reserves for tax purposes would not affect State law requirements for reserves to protect policyholders against company insolvency. State law would continue to require adequate funding of statutory reserves. The tax reserve account would be smaller than the statutory reserve and would be only a bookkeeping entry. The lower tax reserve would increase the current tax liability of P&C companies and affiliated companies, but as described above the proposal would simply eliminate the deferral of tax liability allowed under current law. P&C companies could be expected to increase their premiums to cover any increased tax liability resulting from the more accurate measurement of their taxable income.

The property and casualty industry may argue that this proposal is not appropriate for an industry with large underwriting losses (-$11.0 billion in 1983). However, as shown in Table 2, P&C companies earned total net income of $6.6 billion in 1983, this being the excess of their $17.9 billion of investment income over their underwriting losses. The large underwriting losses occur because P&C companies lower premiums (discount) for the expected future investment income, but they currently do not discount statutory reserves which are used in calculating underwriting income. Total net income is the appropriate measure of company profitability, not underwriting income.

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Table 2

Investment Gain and Underwriting Loss of Property and Casualty Insurance Companies - 1979 to 1983
(In millions of dollars)

Year	Net Underwriting Gain or Loss	Net Investment Gain or Loss	Other Miscellaneous Income	Total Net Income 1/
1979	$ - 21	$ 9,607	$ - 161	$ 9,424
1980	-1,819	11,628	- 208	9,601
1981	-4,563	13,520	- 265	8,692
1982	-8,302	15,479	- 406	6,771
1983	-11,033	17,923	- 306	6,584

Office of the Secretary of the Treasury
Office of Tax Analysis

November 29, 1984

1/ Before policyholder dividends.

Source: Best's Aggregates and Averages.

The principal advantage of the qualified reserve account method of discounting reserves is that it assures that the ultimate after-tax return that a company realizes on a group of policies does not depend on the amount the company places into the reserve for those policies, assuming that the company's tax rate is constant over time. In fact, the qualified reserve account method would yield the same ultimate after-tax return as the cash method of accounting, although it would achieve a better matching of income and deductions on a year-by-year basis. This means that it would be unnecessary to prescribe a Federal standard for discounting reserves -- companies are free to discount using any reasonable set of assumptions (e.g., the assumptions used in pricing the policies). A company would not have a tax incentive to overreserve since any excess tax deduction would be recaptured when the claims are ultimately paid with an interest factor equal to the company's actual after-tax rate of return. Conversely, companies that underreserve would receive additional deductions at the time they pay their claims to ensure that they will not be penalized for underreserving.

REPEAL MUTUAL PROPERTY AND CASUALTY INSURANCE COMPANY PROTECTION AGAINST LOSS ACCOUNT

General Explanation

Chapter 12.11

Current Law

Most mutual property and casualty (P&C) insurance companies are allowed deductions for net contributions to a protection against loss (PAL) account. A deduction is generally allowed for contributions to the account in an amount equal to one percent of the losses (both known and estimated) incurred during the taxable year plus 25 percent of the underwriting gain for the taxable year. Companies that have a high percentage of risks relating to windstorms, hail, flood, earthquakes, or similar hazards may defer a larger percentage of their underwriting income.

The portion of the deferred income representing one percent of losses incurred and one-half of the deduction for 25 percent of underwriting income is brought back into income after, at most, a five-year deferral period. The remaining amount, 12.5 percent of underwriting income, continues to be deferred indefinitely, until the company has underwriting losses.

Reasons for Change

The special PAL deduction is unrelated to the measurement of economic income. The PAL deduction is allowed in addition to the full deduction that mutual P&C companies receive for estimates of future losses. Furthermore, the PAL account is simply a bookkeeping entry made for tax purposes; a corresponding reserve account is not required by State regulatory authorities to provide for the financial solvency of the companies.

The tax deferral resulting from the deductibility of contributions to a PAL account reduces the effective tax rate on mutual P&C companies with underwriting income. The lower effective tax rate provides a competitive advantage to mutual P&C companies vis-a-vis stock P&C companies and life insurance companies that offer similar insurance products.

The calculation of the PAL account requires an arbitrary distinction between underwriting and investment income. This distinction increases the complexity of the tax code and increases the possibility that companies will undertake uneconomic transactions solely to minimize tax liability.

Proposal

The deduction for contributions to a PAL account would be repealed. Amounts currently held in the account would be included in income no later than ratably over a five-year period.

Effective Date

The proposal would apply to taxable years beginning on or after January 1, 1986.

Analysis

The benefits of the special PAL deduction accrue largely to profitable companies that do not have underwriting losses and therefore obtain the maximum tax deferral. The special deduction provides little benefit to companies with periodic underwriting losses. Repeal of the special PAL deduction should have minimal impact on premium rates.

REPEAL SPECIAL TAX EXEMPTIONS, RATE REDUCTIONS, AND DEDUCTIONS OF SMALL MUTUAL PROPERTY AND CASUALTY INSURANCE COMPANIES

General Explanation

Chapter 12.12

Current Law

Numerous special rules reduce or eliminate the tax liability of certain small mutual property and casualty (P&C) insurance companies. Mutual P&C companies with taxable investment and underwriting income of not more than $6,000 are exempt from tax; a limitation on the rate of tax on income in excess of $6,000 phases out between $6,000 and $12,000. Mutual P&C companies that during the taxable year receive a gross amount of not more than $150,000 from premiums and certain investment income are also exempt from tax, regardless of the amount of their taxable income. Unless they elect to the contrary, companies that receive a gross amount from premiums and certain investment income of more than $150,000 but not more than $500,000 are taxed only on their investment income (and are not taxed at all if their investment income is not more than $3,000); their underwriting income is exempt from tax. A limitation on the rate of tax on the investment income of such companies in excess of $3,000 phases out between $3,000 and $6,000. A further reduction of the rate of tax on the investment income of such companies phases out as the gross amount from premiums and certain investment income increases from $150,000 to $250,000. Finally, mutual P&C companies that receive a gross amount from premiums and certain investment income of less than $1,100,000 are allowed a special deduction against their underwriting income (if it is subject to tax). The maximum amount of the deduction is $6,000, and the deduction phases out as the gross amount increases from $500,000 to $1,100,000.

Reasons for Change

The special tax rules that reduce or eliminate the tax liability of certain small mutual P&C companies provide competitive advantages to those companies vis-a-vis stock companies and larger mutual companies. The application of these rules requires arbitrary distinctions between underwriting and investment income, thereby increasing the complexity of the tax code.

Proposal

The special tax exemptions, rate reductions, and deductions of small mutual P&C companies would be repealed.

Effective Date

The proposal would be phased in over a five-year period, starting with the first taxable year beginning on or after January 1, 1986.

Analysis

Small mutual P&C companies would be placed on a par with all other P&C companies and other small corporations. Elimination of preferential rates based on the size of the firm would end tax-induced distortions that favor the sale of insurance through small firms.

LIMIT MUTUAL PROPERTY AND CASUALTY INSURANCE COMPANY DEDUCTION FOR POLICYHOLDER DIVIDENDS

General Explanation

Chapter 12.13

Current Law

In general, stock and mutual property and casualty (P&C) insurance companies are allowed to deduct dividends and similar distributions paid or declared to policyholders in their capacity as such. These distributions are treated by policyholders as price rebates rather than as taxable distributions. Because policyholder dividends distributed by mutual companies are substantially larger than similar distributions by stock companies, this deduction primarily benefits mutual P&C companies.

In the case of life insurance companies, the amount of the deduction allowed mutual companies for policyholder dividends is subject to certain limitations. The deductibility constraint stems from a recognition that policyholder dividends paid by mutual companies are, to some extent, distributions of the companies' earnings to policyholders in their capacity as owners of the company. Consequently, the deduction for policyholder dividends is reduced by an amount determined to be the owner/policyholder's share of the distributed earnings of the company.

Reasons for Change

The allowance of a deduction for income distributed in the form of policyholder dividends by mutual P&C companies provides a competitive advantage to such companies vis-a-vis stock P&C companies and other corporations. This competitive advantage of mutual companies was recognized in the 1984 overhaul of the life insurance company tax rules, which imposed a limitation on the deductibility of policyholder dividends by mutual life insurance companies. A similar limitation on the deductibility of mutual P&C company policyholder dividends would ensure that corporate profits are taxed at least once, thereby reducing the distortion caused by the deduction.

Proposal

The deduction for policyholder dividends allowed mutual P&C companies would be reduced in a manner similar to the way in which the deduction for policyholder dividends allowed mutual life insurance companies is reduced under current law.

Effective Date

The proposal would be effective for taxable years beginning on or after January 1, 1986.

Analysis

The proposal would subject all income of mutual P&C companies, including profits distributed to policyholders, to tax at the company level. Mutual companies may distribute a lesser amount of policyholder dividends and charge slightly higher premiums as a result of the tax on equity income, similar to the effect of corporate taxes on other companies. The advantage of mutual companies over stock companies would be reduced, as would the advantage of mutual P&C companies selling insurance products in competition with life insurance companies.

Part D. Tax Exemption for Insurance Companies

REPEAL TAX EXEMPTION FOR CERTAIN INSURANCE COMPANIES

General Explanation

Chapter 12.14

Current Law

Current law exempts from Federal income tax a large and diverse group of nonprofit organizations. These organizations are, however, taxable on income received from the conduct of business that is unrelated to the organization's exempt purpose. Although the sale of insurance by tax-exempt organizations generally is an unrelated trade or business, there are numerous organizations that engage in the insurance business without tax liability. Current law expressly provides a tax exemption for the insurance activities of some organizations, including: certain fraternal beneficiary societies that provide for the payment of insurance benefits to their members; voluntary employee beneficiary associations that provide insurance benefits to their members; local benevolent life insurance associations; mutual insurance companies or associations (other than life or marine) if the gross amount received from certain sources does not exceed $150,000; trusts for the payment of supplemental unemployment benefits; Black Lung trusts; veterans' organizations; and shipowners' protection and indemnity associations. In addition, some organizations that sell insurance have been held to be tax exempt under provisions of law exempting from tax religious, charitable, or educational organizations and social welfare organizations.1/

Reasons for Change

The statutory tax exemptions for the organizations listed above generally were enacted at a time when large parts of the United States were rural and agricultural, and when many individuals and businesses were unable to obtain insurance from commercial companies. Similarly, tax-exempt status was recognized by the courts and the Internal Revenue Service for certain organizations because they met a need that was not met by the commercial sector. These organizations generally were small and had little income.

1/ Where an insurance organization's exempt status is not expressly mandated by statute but rather has been recognized under a more general provision for exempt status, the Internal Revenue Service has authority to revoke the organization's exemption if it is no longer justified.

Today, tax-exempt insurance companies are generally indistinguishable from their taxable counterparts. They sell the same products as taxable insurance companies and compete with taxable companies for business. Several insurance companies that are exempt from tax rank among the largest insurance companies in the United States.

All businesses that sell insurance should be treated equally. Retention of tax-exempt status for some insurance companies would give those companies an unfair competitive advantage. The absence of a tax burden on these companies may be reflected in lower premiums charged to policyholders, thereby giving individuals who are able to purchase insurance from one of these companies an advantage over other individuals.

Proposal

Existing tax exemptions for insurance businesses would be repealed. In general, these insurance businesses would be taxed under the rules applying to taxable corporations. Any organization qualifying as a life insurance company or property and casualty insurance company would be taxed under the rules applying to that type of company. Special rules would be provided for certain organizations that are not subject to the same system of regulation for State law purposes as other insurance companies or that have relatively small insurance activities.

The providing of insurance at less than cost to a class of charitable recipients would continue to be recognized as a charitable activity entitled to exemption from Federal income tax.

Effective Date

The proposal would be phased in over a five-year period, starting with the first taxable year beginning on or after January 1, 1986.

Analysis

Nonprofit organizations providing insurance in competition with taxable stock and mutual insurance companies would be placed on a par with their competitors. Elimination of the tax exemption would end tax-induced distortions that favor the provision of insurance through tax-exempt organizations and that favor individuals who have access to insurance sold by these organizations.

CHAPTER 13

STATE AND LOCAL GOVERNMENT DEBT AND INVESTMENTS

This Chapter discusses proposals to limit the tax exemption of interest on State and local obligations to its proper scope -- the financing of governmental activities, such as schools and roads for State and local governments. Future issues of nongovernmental bonds would not be exempt from Federal income tax. Restrictions on arbitrage with respect to tax-exempt obligations would be tightened, and advance refundings would be prohibited. Finally, the general stock ownership corporation provisions would be repealed as superfluous.

REPEAL TAX EXEMPTION FOR NONGOVERNMENTAL BONDS

General Explanation

Chapter 13.01

Current Law

Interest on State and local obligations generally is exempt from Federal income tax. In many cases, proceeds from the issuance of tax-exempt bonds are made available for use by private businesses, certain tax-exempt organizations, homeowners and students, as well as for use by State and local governments.

Industrial development bonds. State and local government obligations are classified as industrial development bonds (IDBs) if the bond proceeds are to be used in any trade or business carried on by a nonexempt person and the payment of principal or interest on the bonds is derived from or secured by money or property used in a trade or business. Interest on IDBs as a general rule is taxable, but interest on two categories of IDBs is tax exempt: (1) IDBs that qualify as exempt small issues, and (2) IDBs issued to finance certain exempt activities.

Exempt small issue IDBs can be issued in amounts of $1 million or less to assist any principal user in the acquisition, construction or improvement of land or depreciable property located in any one city or county. The $1 million limitation may be increased to $10 million if the aggregate amount of capital expenditures of the principal users in the particular jurisdiction do not exceed $10 million over a six-year period. Current law also provides an exemption for interest on IDBs used to finance certain specific exempt activities. Any land, buildings or other property that is functionally related and subordinate to the exempt facility also may be financed through tax-exempt bonds.

Mortgage subsidy bonds. State and local governments may issue mortgage subsidy bonds to finance mortgages on owner-occupied residences. There are two categories of mortgage subsidy bonds that are tax-exempt: (1) qualified mortgage bonds, and (2) qualified veterans' mortgage bonds. Qualified mortgage bonds provide mortgage financing for qualified homebuyers. Qualified veterans' mortgage bonds provide mortgage financing for certain veterans, but may be issued only by States with programs in place before June 22, 1984.

Other nongovernmental bonds. Tax-exempt obligations may be issued for certain tax-exempt organizations such as nonprofit hospitals and educational institutions. Tax-exempt student loan bonds may be issued to finance educational and related expenses by nonprofit corporations or public agencies or instrumentalities of a State. Finally, other tax-exempt bonds that are not IDBs may be used to provide financing to nongovernmental entities and individuals.

Reasons for Change

The exemption from Federal income tax of interest on State and local government obligations exists as a matter of comity between the Federal government and State and local governments. This tax exemption lowers the cost to State and local governments of financing public facilities, such as schools, roads and sewers. Increasingly, however, State and local governments have used their tax-exempt financing privilege to obtain funds for use by nongovernmental persons. Thus, State and local tax-exempt obligations are now commonly used to provide financing for private businesses, residential mortgages, nonprofit corporations and student loans. A total of $58 billion of such nongovernmental bonds was issued in 1983, accounting for 61 percent of all long-term tax-exempt bonds issued that year.

Tax-exempt nongovernmental bonds have caused serious erosion in the Federal income tax base, lowering tax receipts and forcing increases in the tax rates on nonexempt income. The revenues lost as a result of tax-exempt nongovernmental bonds represent an indirect Federal subsidy program, based in the tax code, and thus significantly free of the scrutiny that attaches to direct Federal expenditures. In many cases, the issuer of nongovernmental bonds would not spend its own revenues to support the activities that are Federally subsidized through tax-exempt nongovernmental bonds.

Tax-exempt nongovernmental bonds also have anti-competitive and distortive effects on the economy. Activities receiving tax-exempt financing have a significant advantage over their competitors, which must raise capital with higher-cost taxable obligations. Yet, the availability of tax-exempt financing for nongovernmental persons depends upon which jurisdiction has the necessary programs in place and upon the ability of persons to negotiate through obstacles of State and local law and procedure. These factors have little relation to the value or efficiency of particular activities, and ought not to influence the allocation of capital among sectors of the economy.

Finally, the volume of tax-exempt nongovernmental bonds has worked to the deteriment of bonds issued to provide financing for State and local governments. As a result of the issuance of these additional securities, tax-exempt interest rates must rise in order to attract additional capital. This increases costs for State and local governments, with no corresponding increase in the level of government services provided. Moreover, these increased costs are borne by all State and local governments, not simply those issuing nongovernmental bonds.

Proposal

Interest on obligations issued by a State or local government would be taxable if more than one percent of the proceeds were used directly or indirectly by any person other than a State or local government. Generally, use of a facility financed with proceeds of tax-exempt obligations would be considered to be use of those proceeds. There would be an exception from this general rule for use by nongovernmental persons of tax-exempt financed facilities if the facilities were used by the general public and if such use were on the same basis as for all members of the general public. In addition, a de minimis exception would allow use of tax-exempt financed facilities by a nongovernmental person pursuant to a short-term management contract. Allocation rules would permit tax-exempt financing for a proportionate share of the cost of a facility used in part for public and in part for private purposes. Finally, an exception to the nongovernmental use rule would permit bond proceeds to be (a) used to fund a reasonably required reserve fund, (b) invested for the initial temporary period before use for the governmental purpose of the borrowing, or (c) deposited in a bona fide debt service fund.

The proposal would preserve the tax exemption for obligations issued to finance ordinary government operations, such as tax anticipation notes, as well as those issued to finance the acquisition or construction of government buildings. If the government leased a portion of a building to a nongovernmental person for more than a brief interim period, however, the portion so leased could not be financed with tax-exempt obligations.

Obligations issued to acquire or construct facilities to be used by the general public would also continue to be tax-exempt so long as no nongovernmental person uses the facility (or has access to the facility) on a basis other than that applicable to the general public. (For example, extension of a road, sewer or other system serving the general public to a newly constructed house or business could be financed on a tax-exempt basis. On the other hand, construction of an airstrip adjacent to a business that would be its sole user could not be financed through the issuance of tax-exempt bonds.) Thus, a solid waste disposal facility serving the general public could be financed with tax-exempt obligations if it were owned by a city and operated by the city or by a private manager under a short-term management contract. If the proceeds of the financing were made available to a nongovernmental person to construct a privately-owned solid waste disposal facility, however, the bonds would not be tax exempt.

The proposal would extend certain of the requirements under current law, such as the IDB reporting requirements, to all tax-exempt bonds and would retain certain other existing restrictions, such as the prohibition against Federal guarantees. Most other provisions of code section 103 would be repealed. The proposal would assure governmental control over tax-exempt bond issues and the facilities they finance by the requirement that issuers be a State or a local government rather than an "on behalf of" issuer or a nonprofit corporation. Since State and local governments would no longer be entitled to issue mortgage subsidy bonds under the proposal, the mortgage credit certificate program would no longer operate.

Effective Date

The proposal would be effective for obligations issued on or after January 1, 1986. A transition rule would be provided for current refundings of outstanding obligations if the refunding does not extend the weighted average maturity date of the obligations outstanding at the time of the refunding or exceed the outstanding amount of the refunded obligation.

Analysis

The proposal would replace the standard for tax-exemption in current law, which grants tax-exempt status to obligations on the basis of their qualifying as student loan bonds, mortgage subsidy bonds, veterans' mortgage bonds, small issue IDBs, exempt activity IDBs or other tax-exempt non-IDBs, with a new standard for determining the tax-exempt status of obligations. The proposal would virtually eliminate (rather than limit through a volume ceiling) the Federal subsidy currently made available to nongovernmental persons through tax-exempt financing. State and local governments would, however, retain the ability to finance projects with tax-exempt obligations if the proceeds are not used by nongovernmental persons.

Elimination of nongovernmental tax-exempt bonds would cause the spread between tax-exempt and taxable interest rates to increase, due to a lower volume of tax-exempt obligations. Thus, the value of the Federal subsidy provided to governmental activities financed with tax-exempt bonds would increase. The proposal would, of course, increase financing costs for nongovernmental persons currently receiving tax-exempt financing. Such increase, however, would simply restore parity among all nongovernmental persons in the competition for capital.

LIMIT TAX ARBITRAGE AND ADVANCE REFUNDING FOR TAX-EXEMPT BONDS

General Explanation

Chapter 13.02

Current Law

Interest on State and local obligations generally is exempt from Federal income tax. An issuer of tax-exempt bonds may borrow at tax-exempt rates and earn "arbitrage" by investing the borrowed amounts in obligations that pay higher returns. Current law denies tax-exempt status to interest on bonds issued with the expectation that the proceeds will be used to earn arbitrage in excess of specified amounts.

Restrictions on Arbitrage. Treasury regulations apply different arbitrage restrictions to different types of obligations acquired with bond proceeds. "Acquired purpose obligations" are obligations acquired to carry out the purpose of the bond issue. Permissible arbitrage on acquired purpose obligations generally is limited to a spread between the yield on the bonds and the yield on the acquired purpose obligations of 0.125 percent plus reasonable administrative costs. Administrative costs basically are the costs of issuing, carrying and repaying the bonds, the underwriter's discount, and the costs of acquiring, carrying, redeeming or selling the obligation of the bond user. All obligations other than acquired purpose obligations acquired with bond proceeds are "acquired nonpurpose obligations." The arbitrage spread for investments of bond proceeds in acquired nonpurpose obligations is restricted to 0.125 percent plus certain costs. There are two principal exceptions to these rules. First, unlimited arbitrage is permitted on bond proceeds invested for a temporary period prior to use, without regard to whether such proceeds are held by the user or the issuer. The temporary period is generally three years for new money financings and up to two years for a refunding transaction. An issuer may waive the temporary period and receive an arbitrage spread of 0.5 percent plus allowable costs with respect to obligations subject to yield restrictions. Second, unlimited arbitrage is permitted on investments held in a reasonably required reserve or replacement fund ("4R fund"). Additional arbitrage restrictions apply to other types of tax-exempt obligations, as discussed below.

Calculation of Yield. The limitations on permissible arbitrage earnings under current law require a comparison of the yield on the bonds and the yield on the acquired obligations. In computing yield, current law permits various costs to be taken into account that either increase bond yield or decrease acquired obligation yield. The result is to increase the amount of permissible arbitrage that issuers may earn. One court has held that bond yield is the discount rate at which the present value of all payments of principal and interest on the bonds equals the net proceeds of the issue after deducting the costs of issuing the bonds. Permitting issuance costs to reduce net proceeds results in a corresponding increase in the bond yield. The effect of calculating bond yield in this fashion is that the bond issuer is permitted to earn an amount equal to issuance costs out of arbitrage. This method of calculating bond yield does not apply for mortgage subsidy bond rebate purposes, where bond yield is based on the initial offering price to the public (excluding bond houses and brokers). In addition, premiums paid to insure a bond issue are treated as additional interest on the issue (to the extent that the present value of the premiums does not exceed the present value of the interest savings) with a resulting increase in the yield on the bond issue. Similarly, the yield on acquired purpose obligations is calculated by excluding from the payments to be received with respect to such obligations a portion of the payments having a present value equal to the costs of issuing, carrying or repaying the bonds, the underwriter's spread and the costs of purchasing, carrying, redeeming or selling acquired purpose obligations. The bond issuer cannot use the same cost to both increase bond yield and decrease yield on acquired obligations.

Advance Refundings. Current law permits the advance refunding of certain tax-exempt bonds. For this purpose, an advance refunding generally is defined as the issuance of bonds to retire another bond issue on a date after the issuance date of the refunding bonds. Advance refundings of industrial development bonds and mortgage subsidy bonds are generally prohibited. For industrial development bonds and mortgage subsidy bonds, however, an advance refunding is defined as the issuance of bonds to retire another bond issue more than 180 days after the issuance date of the refunding bonds. Permissible arbitrage on advance refunding issues, in addition to that earned during any applicable temporary period, basically is limited to interest on $25,000 at the bond rate, plus an amount sufficient to recover reasonable administrative costs.

Special Arbitrage Rules for Certain Bonds. Current law applies special arbitrage rules to certain types of tax-exempt bonds. Mortgage subsidy bonds are permitted to earn an arbitrage spread of 1.125 percent on acquired purpose obligations (the mortgages). Arbitrage earned on nonpurpose obligations must be paid to the mortgagors or to the United States. The amount of bond proceeds that can be invested in nonpurpose obligations at a yield above the bond yield is limited to 150 percent of annual debt service for the bond year. Certain industrial development bonds issued after December 31, 1984, are subject to an arbitrage rebate requirement and a limitation on investment in nonpurpose obligations similar to those imposed on mortgage subsidy bonds. Student loan bonds and other obligations issued in connection with certain governmental programs are generally permitted an arbitrage spread of 1.5 percent plus reasonable administrative costs on the acquired purpose obligations. Interest subsidies paid by the Department of Education can be excluded in determining yield on the acquired purpose obligations (student loans) for student loan bond issues.

Reasons for Change

Under current law, the exclusion from Federal income tax of interest on State and local government obligations provides two separate benefits to State and local issuers. The basic benefit is the reduction in interest cost for the financing. The additional benefit, however, is the ability of the issuer to invest bond proceeds to earn arbitrage. Arbitrage consists of the amounts directly permitted as arbitrage spread and amounts earned when yield restrictions do not apply. By virtue of the definition of yield, the spread includes issuance costs and bond insurance premiums.

Current law is overly generous in that it allows issuers or bond users to retain the economic benefit of all permissible arbitrage, even though many of the rules permitting arbitrage (those for temporary periods and 4R funds, for example) are intended only to reduce the complexity of the arbitrage restrictions. Moreover, because the current rules generally prevent only the issuance of bonds that are expected to earn arbitrage and do not prohibit the retention of arbitrage ultimately earned, issuers and bond users often are rewarded with substantial amounts of "unexpected" arbitrage.

Arbitrage has two undesirable results. First, it may be used for activities ineligible for tax-exempt bond financing, since arbitrage is not subject to the use limitations applicable to proceeds of tax-exempt bonds. Second, arbitrage also increases the volume of tax-exempt bonds. This increase in volume occurs for several reasons. First, the availability of arbitrage makes feasible bond issues that otherwise would be uneconomical. For example, since issuance costs for advance refundings can be recovered out of arbitrage, such bonds may be issued even though issuance costs dwarf the economic benefit to the issuer or the bond user. Bond counsel and underwriters benefit from the resulting lack of motivation on the part of the issuer to restrain costs. Second, the arbitrage encourages issuers to sell more bonds than are necessary in order to invest the excess proceeds in higher yielding investments. Finally, the arbitrage encourages issuers to sell bonds earlier or keep them outstanding longer than is necessary in order to invest the proceeds to earn the arbitrage. For example, it was recently reported that New York City will earn $3 million in legal arbitrage simply by extending the maturity of its tax anticipation notes five months beyond the date on which the taxes will be collected.

Advance refundings of tax-exempt bonds also have the undesirable effect of increasing the volume of tax-exempt bonds. Advance refundings result in twice as many bonds being outstanding as are required for a given project.

Increased bond volume brought about by arbitrage and advance refundings increases the Federal revenue loss associated with tax-exempt bonds, thereby causing taxpayers all over the country to pay additional taxes to support this subsidy of selected governmental issuers. Furthermore, additional volume in the tax-exempt bond market raises the interest rates that must be paid to finance State and local government projects. This expansion also results in pressure for additional Federal aid for those projects from more jurisdictions because of the increased cost of providing the governmental services.

Proposal

Issuers of tax-exempt bonds would be required to rebate to the United States all arbitrage on acquired nonpurpose obligations (adjusted for gains and losses on the obligations and earnings on the gains and on the arbitrage). Investments in acquired nonpurpose obligations would be limited to 150 percent of annual debt service with exceptions for the initial temporary period and for bona fide debt service funds.

Yield on the bond issue would be determined without regard to the underwriter's discount, costs of issuance, credit enhancement fees or other costs. Calculation of yield on acquired obligations also would be changed to prevent any reduction for costs.

The reasonable expectations test would be clarified to provide explicitly that it only protects inadvertent errors and not intentional acts to create arbitrage. For example, any fund that will be used to pay debt service on an issue will be subject to the rebate requirement regardless of whether its creation or its arbitrage was anticipated at the time of the tax-exempt bond issuance.

Temporary period rules permitting unlimited arbitrage until bond proceeds are used would be made more strict than the current rules. There would be no temporary period for bond issues to finance acquisitions. The temporary period for construction projects would terminate when the project is substantially completed or when an amount equal to bond proceeds has been expended on the project and would in all cases be limited to three years. The right to waive the temporary period and earn a yield exceeding the bond yield by 0.5 percent would be repealed.

Early issuance of bonds for a project would be prohibited. The issuer would be required to spend a significant part of the bond proceeds within one month and spend all bond proceeds (excluding proceeds in a 4R fund) within three years of issuance.

Advance refundings would be prohibited for all tax-exempt bonds. Refundings would be permitted only if the proceeds of the refunding bonds are used immediately to retire the prior bond issue.

Effective Date

The proposal would be effective for obligations issued on or after January 1, 1986.

Analysis

The proposal's rebate requirement would eliminate most of the economic motivation to issue tax-exempt bonds to earn arbitrage. In addition, arbitrage earned on obligations that are issued for governmental functions would not result in a windfall profit for the issuer. Proposed changes in the method of calculating yield and in the reasonable expectations test are necessary to implement the rebate requirement properly.

The prohibition of advance refundings would result in a reduction in the aggregate volume of tax-exempt obligations being issued. Individual bond issues would be limited in size by the proposal's restriction on the amount of investments in acquired nonpurpose obligations. In addition, the period during which bonds may be outstanding would be limited by the proposal's restrictions on temporary periods and early issuance. The reductions in both the overall volume and individual size of bond issues would reduce the Federal revenue cost of tax-exempt bonds and would also reduce the interest costs to issuers of obtaining financing for governmental functions.

State and local governments would continue to fulfill necessary governmental functions. Governmental facilities and services could still be financed on a tax-exempt basis. Issuers, however, would not obtain the unnecessary "double dipping" provided by arbitrage in addition to the basic benefit of reduced interest cost.

The proposal would eliminate many complex provisions in the Code and in the Treasury regulations interpreting the Code. The rules on advance refundings would be unnecessary and those dealing with yield computation would be simplified. The special arbitrage rules for certain bonds under current law also would be unnecessary because these bonds would not be exempt under the proposal for repeal of tax exemption for nongovernmental bonds.

REPEAL GENERAL STOCK OWNERSHIP CORPORATION PROVISIONS

General Explanation

Chapter 13.03

Current Law

Current law authorizes a State to establish a General Stock Ownership Corporation ("GSOC") for the benefit of its citizens. A GSOC meeting certain statutory requirements and making an appropriate election is exempt from Federal income tax. Instead, the shareholders of the GSOC are taxable on their daily pro rata share of the GSOC's taxable income. The GSOC computes its taxable income in the same manner as a regular corporation, but is not eligible for the dividends-received deduction. Losses of a GSOC do not flow through to its shareholders, but the GSOC is allowed as a 10-year net operating loss carryforward.

Current law permits such corporations to be chartered after December 31, 1978, and before January 1, 1984.

Reasons for Change

No GSOC has been organized under this law and the period during which they may be formed has expired.

Proposal

The proposal would repeal the law permitting creation of GSOCs.

Effective Date

The proposal would be effective as of January 1, 1984, the sunset date for creation of GSOCs.

Analysis

The complex provisions governing organization and operation of GSOCs have never been utilized. Repeal of these provisions would simplify the Code and have no economic effect. There would be no impact on revenues or expenditures as a result of implementing this proposal.

CHAPTER 14

SPECIAL EXPENSING AND AMORTIZATION RULES

This Chapter discusses Treasury Department proposals that, in conjunction with the proposed Real Cost Recovery System, provide the recovery of capital investment on a basis that reflect economic depreciation. Thus, the special rules allowing rapid amortization for various types of capital investment would be repealed. As a simplification measure, the provision allowing $5,000 of certain capital investments to be expensed annually would be retained. The scheduled increases in the limit would be eliminated.

RETAIN $5,000 LIMIT ON EXPENSING DEPRECIABLE BUSINESS PROPERTY

General Explanation

Chapter 14.01

Current Law

Under current law, taxpayers may elect to expense the cost of a limited amount of qualifying property rather than to recover such cost over time through deductions for depreciation. In general, property qualifying for this expensing election must be purchased for use in a trade or business and must otherwise be eligible for the investment tax credit. No investment credit is allowable with respect to amounts expensed under this rule.

For taxable years beginning before 1988, the dollar limitation on the amount that may be expensed is $5,000 per year. This limitation is scheduled to increase to $7,500 for taxable years beginning in 1988 and 1989, and to $10,000 for taxable years beginning after 1989. In each case, the limitation that applies to a married individual who files a separate return is one-half of the dollar limitation described above.

Reasons for Change

Expensing the cost of an asset that produces income for more than one year overstates the taxpayer's cost of producing income for the year. The overstatement of current deductions shelters other income from tax and thus results in a deferral of tax liability. This deferral advantage creates some incentive for investment in assets eligible for expensing, but only for taxpayers who would not otherwise have acquired qualifying property up to the amount eligible for expensing. For other taxpayers, the limited expensing election creates no marginal investment incentive.

In addition, permitting taxpayers to expense the cost of an asset creates compliance problems. After the year in which the asset is expensed, the asset is removed from the tax form. As a result, it is relatively easy to convert the asset to personal use or to sell the asset without complying with the rules requiring recapture of the deduction.

A limited expensing election does, however, have certain simplification advantages. For smaller businesses, expensing eliminates or reduces the recordkeeping and computational burdens of recovering an asset's cost over a number of years.

Proposal

The scheduled increase of the dollar limitation on expensing of depreciable business property would be eliminated, leaving the dollar limitation at $5,000.

Analysis

The proposal would not change the current treatment of any taxpayer. Elimination of the increase in the limitation should have little effect on investment in depreciable assets. The proposal would simply retain a *de minimis* alternative to the more complicated depreciation rules.

REPEAL RAPID AMORTIZATION RULES

General Explanation

Chapter 14.02

Introduction

Current law contains a number of special amortization and expensing rules that allow taxpayers to elect premature deductions for capital expenditures. The deferral of income tax that these provisions permit is intended to create incentives or subsidies for investment in certain assets or activities.

Some of these provisions originally were intended to be effective only for brief periods, but were later extended. Others have expired in whole or in part since they do not apply to expenditures made in the current year or in future years. Although these provisions target various industries and various assets, they have similar effects on the efficiency and fairness of the tax system and present related questions of tax and economic policy.

Current Law

1. **Five-year amortization of trademark and trade name expenditures.** Current law permits taxpayers to amortize over a period of at least 60 months any expenditure paid or incurred in the taxable year for the acquisition, protection, expansion, registration, or defense of a trademark or trade name, other than an expenditure which is part of the consideration for an existing trademark or trade name. (Section 177.) A separate election may be made by the taxpayer with respect to each separate trademark or trade name expenditure.

2. **Five-year amortization of pollution control facilities.** Current law permits taxpayers to amortize the cost of a certified pollution control facility over a 60-month period. (Section 169.) To the extent, however, that a pollution control facility has a useful life in excess of 15 years, or, in the case of recovery property, has a recovery period in excess of 15 years, a portion of the facility's cost is not eligible for 60-month amortization, but must be recovered through depreciation or through the Accelerated Cost Recovery System (ACRS).

A certified pollution control facility is a treatment facility used in connection with a plant or other property to abate or control water or air pollution, if (1) the plant or other property was in operation before January 1, 1976, (2) the facility is certified by the appropriate State and Federal authorities as meeting certain pollution control standards, and (3) the facility does not significantly increase the output, extend the life, or reduce the operating costs of the plant or other property. In general, a profitable or "break even" facility is not eligible for certification.

If an election is not made with respect to a certified pollution control facility, its cost may be recovered through depreciation or, in the case of recovery property, through ACRS.

3. **Five-year amortization of certain expenditures for qualified child care facilities.** Current law permitted employers to amortize over a 60-month period capital costs incurred before January 1, 1982, to acquire, construct, or rehabilitate child care facilities for their employees. (Section 188.)

4. **Five-year amortization of expenditures to rehabilitate low-income housing.** Current law permits taxpayers to amortize over a 60-month period expenditures to rehabilitate low-income rental housing (other than hotels or other similar facilities primarily serving transients). (Section 167(k).) Expenditures qualify for 60-month amortization only if they are incurred for additions or improvements to property with a useful life of at least five years. Expenditures for a taxable year with respect to a dwelling unit are eligible for 60-month amortization only if the aggregate of such expenditures over two consecutive taxable years including the taxable year exceeds $3,000. In general, a taxpayer's rehabilitation expenditures with respect to a dwelling unit are not eligible for five-year amortization to the extent that the aggregate of such expenditures exceeds $20,000. In certain cases, this limitation is increased to $40,000.

The election to amortize expenditures to rehabilitate low-income housing will not be available for expenditures incurred afer December 31, 1986 (except in cases where rehabilitation began, or a binding contract for such expenditures was entered into, before January 1, 1987).

5. **Five-year amortization of certain railroad rolling stock.** At the election of the taxpayer, current law permitted taxpayers to amortize over a 60-month period the adjusted basis of railroad rolling stock placed in service after 1968 and before 1976. (Section 184.)

6. **Fifty-year amortization of qualified railroad grading and tunnel bores.** Current law permits domestic railroad common carriers to amortize the cost of qualified railroad grading and tunnel bores over a 50-year period. (Section 185.) "Qualified railroad grading and tunnel bores" include all land improvements (including tunneling) necessary to provide, construct, reconstruct, alter, protect, improve, replace, or restore a roadbed or right-of-way for railroad track.

Amortizable basis is not reduced upon the retirement of qualified railroad grading or tunnel bores, but no additional deduction is allowed on account of such retirement.

7. **Expensing of soil and water conservation expenditures, fertilizer and soil conditioning expenditures, and field clearing expenditures.** Current law permits taxpayers engaged in the business of farming ("farmers") to deduct a variety of costs that would otherwise be capitalized or inventoried.

a. Farmers may deduct currently soil and water conservation expenditures that do not increase the basis of depreciable assets. (Section 175.) The deduction is limited annually to 25 percent of the taxpayer's gross income from farming. Deductible expenditures include costs of the following: leveling, grading, and terracing; contour furrowing; the construction, control, and protection of diversion channels, drainage ditches, earthen dams, watercourses, outlets, and ponds; the eradication of brush; and the planting of windbreaks. Expenditures with respect to land held by the taxpayer for less than ten years are subject to recapture as ordinary income.

b. Farmers may deduct currently expenditures for fertilizer or other material used to enrich, neutralize, or condition farmland. (Section 180.)

c. Farmers may deduct currently expenditures incurred to clear land and make the land suitable for farming. (Section 182.) The deduction is limited in any taxable year to the lesser of $5,000 or 25 percent of the farmer's taxable income from farming. Expenditures with respect to land held by the taxpayer for less than ten years are subject to recapture as ordinary income.

8. **Seven-year amortization of reforestation expenditures.** Current law permits taxpayers to amortize over an 84-month period up to $10,000 of reforestation expenditures incurred in each taxable year. (Section 194.) Reforestation expenditures include amounts spent on site preparation, seed or seedlings, labor, and tools. Amortized expenditures are subject to recapture if the underlying property is disposed of within ten years from the year of the expenditure.

Reasons For Change

Summary

Government subsidies for particular industries and assets distort market-based resource allocations and the consumer preferences on which they are based. In circumstances where private markets fail to reflect the social value of particular goods or services, government intervention in the form of a subsidy may be appropriate. However, many recently enacted tax incentives for business do not address problems of market failure, but instead subsidize specific business activities at some cost in economic efficiency.

Even where government support of a particular activity is warranted, providing such support through the allowance of premature cost recovery deductions results in a subsidy that is difficult to measure or control, discriminatory in its effects, and poorly targeted to encourage the particular form of investment.

The value to a taxpayer of premature cost recovery deductions depends on a variety of factors unrelated to the purpose of the subsidy. For example, the benefit from premature deductions will depend upon the difference in the taxpayer's marginal tax rate for the years in which the premature deductions are taken and the marginal rates for the years in which deductions would have been allowed under general tax accounting principles. Similarly, interest rates and the level of inflation over the same period will affect the actual value of the premature deductions.

In addition, since the benefit from premature cost recovery deductions is greater for taxpayers with high current marginal tax rates, incentives in that form discriminate against new businesses which have not started to generate taxable income, as well as growing businesses which reinvest their profits in ways that reduce current taxable income. Thus, such businesses are encouraged to diversify through expansion or merger solely to increase their taxable income.

A subsidy in the form of premature cost deductions is also difficult to target. Ideally, the incentive should benefit the most efficient owners of the asset to which the subsidy is directed. Since the subsidy's value is dependent on marginal tax rates, however, there is a strong incentive for subsidized assets to be owned by taxpayers in the highest brackets, who may or may not be efficient owners.

Finally, a subsidy in the form of premature cost recovery deductions is difficult to monitor or control. The contingencies in the value of the subsidy make prediction of its revenue cost extremely difficult. Problems in targeting the subsidy make it difficult to measure the subsidy's effect, which may in turn result in the subsidy being retained beyond the point at which it provides an efficient incentive.

1. **Trademark and trade name expenditures.** A trademark or trade name distinguishes a firm and/or its products from other firms and/or their products. The costs of acquiring trademarks are capital outlays for an intangible asset, similar to expenditures to organize a business. Investors are willing to make such expenditures because in doing so they acquire an asset that will, over the course of time, yield a rate of return at least as high as could be earned by other investments. Although a trademark or trade name may prove to be unprofitable, or even worthless, there can be no presumption that it will decline in value. To the contrary, the ordinary investor acquiring a trademark or trade name expects the value of the asset to appreciate along with the development of the products that it represents. There is consequently no basis for imputing deductions for "capital cost recovery" for such investments.

There is no evidence that investment in a trademark or trade name yields a greater benefit to society than is reflected in the expected market return to the investor. Allocation of resources to such investment should thus be determined by general market principles. There is correspondingly no basis for a tax incentive through premature recovery of the costs of such investment.

2. **Certified pollution control facilities.** The special amortization rules for pollution control facilities were enacted in 1969, shortly after the enactment of Federal legislation which imposed phased-in restrictions on industrial plant emissions. The thrust of the environmental protection laws was to require producers and their customers to pay the costs of avoiding environmental damage in excess of the standards imposed. At the same time, concern was expressed that existing plants would be subject to burdensome retrofitting costs, which would place them at a competitive disadvantage compared to newer plants that were designed after pollution control requirements were imposed. The special amortization rules were adopted to mitigate the cost of retrofitting older facilities. Consistent with the transitional objective, the special rules were scheduled to expire after seven years (December 31, 1975), a period presumably long enough to bring pre-1969 plants into compliance with emission standards.

The special amortization rules for pollution control facilities are poorly designed to offset the burden, if any, that revised environmental standards imposed on operators of existing plants. Ordinarily, plants in industries where emissions are a major concern are continuously "replaced" and their capacity altered in an orderly process of maintenance, repair, and modernization stages. Thus, at the margin, revised emission standards raised investment and operating costs for "old" and "new" plants alike. The only cost disadvantage to "old" plants was the difference between (a) the total additional cost of incorporating emission control features into "modernization" programs, and (b) the total additional cost of incorporating emission control features into the construction of new plants. This difference, which reflected differences in operating costs as well as capital costs, presumably varied from industry to industry, and from plant to plant. Thus, the extra burden imposed on taxpayers operating old plants, if any, was not related in some simple way to the cost of a depreciable retrofit facility, nor was it approximately equal to the interest savings on deferred taxes provided by five-year amortization.

The five-year amortization rules are also poorly targeted to encourage pollution control activities. The subsidy is available only with respect to depreciable assets, and thus provides no incentive for numerous other ways of reducing pollution from existing plants, such as using cleaner but more expensive grades of fuel and other raw material inputs. Favoring capital intensive pollution control measures wastes scarce resources to accomplish the program objective.

Finally, although the special amortization rule for pollution control facilities was originally a temporary measure, it was extended indefinitely in 1976. Even if some justification existed for transitional relief to operators of old plants, there is no basis for an ongoing subsidy of pollution control costs.

3. **Qualified child care facilities.** The special rule permitting five-year amortization of expenditures to construct or rehabilitate child care facilities applies only to expenditures made before January 1, 1982, and, therefore, has effectively expired.

4. **Rehabilitation of low-income housing.** Historically, low-income housing has benefited from a variety of direct and indirect government subsidies, including rental subsidies, grants, loans, and credit supports and guarantees. A number of Federal programs, including the housing voucher program initiated in 1983, have provided direct or indirect assistance to low-income families unable to afford market rents. Also initiated in 1983 were two programs providing grants to assist private sector rehabilitation and new construction of low-income housing. Direct low-interest loans are made available to assist low-income individuals in rural areas to obtain adequate housing. Finally, a number of mortgage insurance and guarantee programs make credit available to many families who could not afford to purchase homes in the absence of such measures.

In addition to these targeted direct subsidies, the current income tax laws contain numerous provisions which encourage investment in real estate, including housing. These provisions include (1) accelerated depreciation of real property, (2) full deductibility of interest, including the portion of interest intended to compensate the lender for the effects of inflation, (3) reduced tax rates for capital gains realized on disposition of real property, (4) relaxed recapture rules for dispositions of real property, (5) exemption of real estate investments from the limitation of losses to amounts at risk, and (6) tax-exempt status for bonds issued to finance low-income rental property. In addition, several special provisions apply only to low-income housing, including (1) immediate deductibility of construction-period interest and taxes, (2) the 15-year ACRS recovery period, and (3) five-year amortization of rehabilitation expenditures.

The tax benefits associated with real estate investment attract capital from high-income taxpayers who are willing to trade negative cash flows or below-market returns for substantial tax savings, and therefore appear to cause increased investment in real estate, including low-income housing. However, in a 1977 report entitled "Real Estate Tax Shelter Subsidies and Direct Subsidy Alternatives," the Congressional Budget Office estimated that, because of the costs of packaging tax shelters and the high after-tax returns enjoyed by tax shelter investors, less than one-half of government revenue losses attributable to real estate tax shelters ever reach builders and developers. Thus, to the extent that the current tax laws encourage investment in low-income housing, the incentive is unnecessarily costly to the government.

Moreover, the provision permitting five-year amortization of expenditures to rehabilitate low-income housing, by itself, is probably insufficient to cause taxpayers to invest in low-income properties. The tax consequences of such investments are beneficial only in conjunction with accelerated depreciation of other capitalized costs (such as the purchase price of the unrehabilitated property), full deductibility of interest, and high marginal tax rates. In a tax system with economic depreciation, indexation of capital gains and interest, and reduced marginal rates, five-year amortization of rehabilitation expenditures would be of dubious value, and would merely complicate the tax laws.

If additional measures are needed to stimulate investment in low-income housing, existing targeted spending programs should be expanded.

5. Railroad rolling stock. The special rule permitting five-year amortization of the adjusted basis of railroad rolling stock applies only to rolling stock placed in service before 1976, and, therefore, has effectively expired.

6. Qualified railroad grading and tunnel bores. For much of its history, the U.S. railroad industry was subject to rate and service regulation designed to favor shipments of bulk raw materials over shipments of finished and semi-finished products. As a consequence, the industry's capacity to haul bulk commodities, demand for which is highly seasonal in volume, depended heavily on cross-subsidization from rates that were charged for "high value" manufactured goods.

In general, such cross-subsidization was possible so long as the railroad industry held a virtual monopoly on long distance overland haulage. Competition from trucking progressively eroded this monopoly, however, shifting the railroad's mix of transported goods to the low-value markets. Railroad rate schedules failed to keep pace with the shift in markets, depressing industry earnings and causing investment in right of way and rolling stock to decline.

In 1969, Congress responded to the railroad industry's financial plight by allowing 50-year amortization for the cost of railroad grading (the basic roadway, but not the track, ties, and ballast) and tunnel bores, which, as assets in the nature of land improvements, had previously been considered nondepreciable. This special amortization rule, after its expansion in 1976, applied regardless of when the assets were placed in service, effectively granting railroad companies a 50-year stream of tax deferrals.

The special amortization rule for railroad grading and tunnel bores is a poorly conceived subsidy. The value of the subsidy depends on a railroad's historical investment in grading and tunnel bores. In many cases, these costs were incurred prior to imposition of the income tax, and, in any event, are not correlated with regulatory mispricing.

In addition, the subsidy targets its benefits to railroads least in need of or entitled to relief. Those railroads most affected by regulatory mispricing may not have significant taxable income, and thus may realize no benefit from the subsidy. Only profitable railroads can take full advantage of the special amortization rules, yet they may have escaped the burdens that the subsidy is intended to offset.

7. Soil and water conservation expenditures, fertilizer and soil conditioning expenditures, and land clearing expenditures. In recognition of various economic conditions which disfavor small unit farming, often called family farming, Federal programs to mitigate farm price and income instability have been in place since 1926. In addition to price support programs, farmers have access to Federal credit on a subsidized basis. The Department of Agriculture also administers programs for agricultural conservation and rural water supply, as well as providing farmers broad scale technical and management assistance.

The extensive Federal involvement in agricultural input and output markets makes additional tax-based subsidies unnecessary and inefficient. Outlays to drain marshy soil, create ponds, install irrigation ditches, and condition soil, all have the objective of yielding greater farm output in the future; under ordinary accounting principles they should be capitalized or inventoried -- treated as the purchase of an asset -- rather than treated as a cost of the current year's output. If the land-improving investments are rationally made, the farmer has merely exchanged cash for an asset of equal value -- improved land -- the expected market value of which will accrue to him as output occurs.

Finally, as with many other tax-based subsidies, the special expensing rules for farmers are of full value only to those with significant income. This effectively denies the benefits of the subsidy to the new or unprofitable farmer, who is thus given a relative disincentive for farm improvements.

8. Reforestation expenditures. It has been argued that the market price of timber understates the social value of forested land because some important benefits are not expressed in the market price. National security, flood control, arresting land erosion that degrades the quality of streams, and opportunities for outdoor recreation are claimed to be among the additional benefits derived from forested land.

In view of these "externalities," government invervention to increase the volume of forest output may be justified. Thus, $1.8 billion was spent in fiscal year 1984 for management of more than 100 million acres of national forests and for cooperative forestry and forestry research.

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In addition to these direct budget expenditures, present law contains tax subsidies intended to encourage forestry by small-scale landowners. All taxpayers investing in timberland are entitled to an investment tax credit equal to ten percent of up to $10,000 of forestation expenditures each year. In addition, the total amount eligible for the credit may be amortized over seven years, notwithstanding the fact that the taxpayer has expended only 90 percent of that amount and the trees planted are likely to appreciate in value.

Even if one agrees that there are "externalities" in forestry in excess of the direct expenditures presently provided in the Federal budget, the tax subsidy is so poorly designed that its continuation is difficult to justify. Any forestation expenditure qualifies for the investment credit and amortizaton, whether or not it yields recreational, flood control, or erosion control benefits, or relates to a tree species with national security significance. Moreover, the subsidy is so structured that it cannot appreciably affect marginal industry investment. Due to economies of scale, most commercial forestry (i.e., that type which is likely to produce external benefits of the kind that justify a subsidy) occurs on a scale far in excess of $10,000 per year. For most commercial forestry, therefore, the subsidy is the equivalent of a fixed grant, plus assured tax deferral per year, and is independent of the taxpayer's decision to increase marginal qualified expenditures. Consequently, repealing these tax subsidy provisions would reduce the budget deficit without measurably increasing soil erosion and flood damage, or reducing recreational opportunities and national security.

Proposal and Effective Dates

1. **Trademark and trade name expenditures.** The current election to amortize trademark and trade name expenditures would be repealed. Repeal would be effective for expenditures paid or incurred on or after January 1, 1986, other than expenditures paid or incurred pursuant to binding contracts entered into prior to the date that the proposal is introduced in legislation.

2. **Certified pollution control facilities.** The election to amortize the cost of certified pollution control facilities would be repealed. Repeal would be effective for expenditures paid or incurred on or after January 1, 1986, other than expenditures paid or incurred pursuant to binding contracts entered into prior to the date that the proposal is introduced in legislation.

3. **Qualified child care facilities.** This provision would be deleted from the Code as deadwood, since it applies only to costs incurred prior to January 1, 1982.

4. **Rehabilitation of low-income housing.** The election to amortize expenditures to rehabilitate low-income housing would be

repealed. Repeal would be effective for expenditures paid or incurred on or after January 1, 1986, other than expenditures paid or incurred pursuant to binding contracts entered into prior to the date that the proposed is introduced in legislation.

5. **Railroad rolling stock.** This provision would be deleted from the Code as deadwood, since it applies only to rolling stock placed in service prior to 1976.

6. **Qualified railroad grading and tunnel bores.** The election to amortize the cost of qualified railroad grading and tunnel bores would be repealed. Repeal would be effective for expenditures paid or incurred on or after January 1, 1986, other than expenditures paid or incurred pursuant to binding contracts entered into prior to the date that the proposal is introduced in legislation.

7. **Soil and water conservation expenditures, fertilizer and soil conditioning expenditures, and land clearing expenditures.** The elections to deduct currently expenditures for soil and water conservation, fertilizer and soil conditioning, and land clearing, would be repealed. Repeal would be effective for expenditures paid or incurred on or after January 1, 1986, other than expenditures paid or incurred pursuant to binding contracts entered into prior to the date that the proposal is introduced in legislation.

8. **Seven-year amortization of reforestation expenditures.** The election to amortize reforestation expenditures would be repealed. Repeal would be effective for expenditures paid or incurred on or after January 1, 1986, other than expenditures paid or incurred pursuant to binding contracts entered into prior to the date that the proposal is introduced in legislation.

Analysis

In general, costs that currently qualify for the special expensing and amortization rules discussed in this section create wasting or non-wasting long-lived assets. Thus, repeal of the special rules would cause those costs to be capitalized or inventoried, and recovered under the normal cost recovery rules or at the time of disposition. The effect on taxpayer behavior of such repeal would generally depend on (1) the extent to which marginal investment choices are influenced by the special rules provided by current law and (2) the degree of neutrality achieved by the cost recovery rules replacing the special provisions.

1. **Trademark and trade name expenditures.** An investment in a trademark or trade name creates an intangible asset for which there is no reason to impute deductions for a decline in value over time. Accordingly, if such an investment were capitalized it would be recovered only upon disposition of the asset. Thus, the interest-free tax deferral which currently results from the tax treatment of trademark and trade name expenditures would be eliminated.

Nevertheless, the effect of repeal on business would be minimal. Unlike investments in plants and equipment, investments in trademarks and trade names do not vary with firm output. Rather, they are fixed capital costs which are relatively small compared to the initial investment in an enterprise, and constitute a declining proportion of total investment as firm output increases. Thus, the importance of trademark and trade name income tax deferral is initially small and is thereafter of diminishing significance to firms with average rates of growth.

2. **Certified pollution control facilities.** Pollution control facilities that are currently eligible for five-year amortization are for the most part comprised of equipment which, under a system of economic depreciation, would be depreciated over periods longer than five years. Since, under such a system, the relative tax benefit from investing in such equipment, compared to the tax consequences of investing in other means of controlling pollution, would be reduced or eliminated, choices of pollution control methods would be based on economic, rather than tax, considerations. Since compliance with emission control standards is mandatory in most cases, the functional value of investments in pollution control facilities would not decline. However, under a neutral cost recovery system, only the most cost-efficient pollution control methods would be used.

3. **Rehabilitation of low-income housing.** In the absence of five-year amortization of expenditures to rehabilitate low-income housing, such expenditures would be recovered in accordance with the normal rules for depreciating real property. Accordingly, repeal of this amortization provision would reduce to some extent the currently inflated after-tax return earned by investments in low-income housing rehabilitation. Nevertheless, the proposal is not expected to diminish the volume of low-income housing.

A tax preference for "rehabilitated" low-income housing directs private investment toward rehabilitation rather than new construction. New construction, however, even of housing for moderate- and high-income families, increases the stock of housing for low-income occupancy as tenants relocate. Thus, increased rehabilitation induced by tax subsidies largely displaces new construction. Accordingly, repeal of the subsidy would have little effect on the availability of low-income housing.

4. **Qualified railroad grading and tunnel bores.** In the absence of 50-year amortization of expenditures for railroad grading and tunnel bores, such expenditures should generally be capitalized as costs of land improvements, and recovered upon disposition of the improvements or the underlying land. This treatment would be consistent with the nature of the asset created by such expenditures, the value of which generally does not decline over time. In view of the fact that future improvements of and additions to railroad grading and tunnel bores are likely to be insubstantial in relation to improvements and additions of track and rolling stock, repeal of

50-year amortization should not have an appreciable effect on the volume of railroad investment or on after-tax rates of return on such investment.

5. **Soil and water conservation expenditures, fertilizer and soil conditioning expenditures, and land clearing expenditures.** In the absence of special expensing rules for farmers' expenditures for clearing, conditioning, and conserving farmland, some of these expenditures would be capitalized as a cost of improving the land to make it suitable for farming and, as such, would be recovered under normal cost recovery rules. To the extent that farmers who make such investments have significant marginal tax rates (generally large-scale operators and corporations), the loss of tax deferral would make investments in land improvement less attractive than alternative investments, such as investments in farm machinery or in other industries. In addition to the resulting social gain from a better allocation of scarce private capital, eliminating this subsidy could result in a reduced level of Federal expenditures for price-support programs, since expansion of farm acreage would no longer be encouraged by the tax laws.

6. **Reforestation expenditures.** Repeal of seven-year amortization of qualified reforestation expenditures and the associated ten percent investment credit would have no measureable effect on the rate of investment in private forest lands. These incentives are structured so that they do not affect forest investment decisions; they apply only to the first $10,000 of forestation investment, a rate far below the annual size of a viable commercial forestry operation. The existing tax subsidies, however, also benefit farmers and other landowners who use tree planting to control wind-related soil damage or otherwise to improve the value of their land. Absent the current subsidy, this type of tree planting probably would decline and investors would select other investment projects with higher market yields.

CHAPTER 15

OTHER SPECIFIC SUBSIDIES

The Treasury Department proposals would repeal various business subsidies contained in the Code, including the rehabilitation tax credit, the merchant marine capital construction fund provisions, the possession tax credit, and special rules for book, magazine, and discount coupon income. The research and experimentation credit would be retained, but modified to improve its efficiency.

REPEAL TAX CREDIT FOR QUALIFIED REHABILITATION

General Explanation

Chapter 15.01

Current Law

A special investment tax credit (the "rehabilitation credit") is provided for qualified expenditures incurred in connection with the rehabilitation (but not enlargement) of certain old or historic buildings. The credit rate is equal to (a) 15 percent for qualified expenditures incurred in connection with buildings at least 30 years old but less than 40 years old, (b) 20 percent for qualified expenditures incurred in connection with buildings at least 40 years old, and (c) 25 percent for qualified expenditures incurred in connection with certified historic structures of any age. The regular investment tax credit and the energy investment tax credit do not apply to any portion of an expenditure which qualifies for the rehabilitation credit.

The rehabilitation credit is limited to expenditures incurred in connection with buildings that will not be used for lodging (except in the case of certified historic structures), and is available only if the taxpayer elects to use the straight-line recovery method with respect to the expenditures. A rehabilitation must be substantial to qualify for the credit. In general, this requirement is met if rehabilitation expenditures incurred over a 24-month period exceed the adjusted basis of the property at the beginning of that period. In addition, at least 75 percent of the building's external walls must be retained in place.

The 25 percent credit for rehabilitations of certified historic structures is subject to certain additional requirements. In general, the 25 percent credit is not available unless the rehabilitation is certified by the Secretary of the Interior as being consistent with the historic character of the building or the district in which the building is located. Certified historic structures include only (a) buildings listed in the National Register and (b) buildings located in a registered historic district and certified by the Secretary of the Interior as being of historic significance to the district.

In the case of a qualified rehabilitation of a certified historic structure, the basis of the rehabilitated building is reduced by 50 percent of the amount of the credit. The reduction is 100 percent of the credit in the case of other qualified rehabilitations. If a rehabilitation credit is subsequently recaptured, corrective basis adjustments are made (and treated as occurring immediately before the recapture event).

Reasons For Change

As enacted in 1962, the investment tax credit was unavailable for buildings and their structural components. In limiting the credit to tangible personal property, Congress was primarily concerned about the greater average age and lower efficiency of domestic machinery and equipment in comparison with the facilities of major foreign producers.

In 1978, Congress noted a decline in the usefulness of existing, older buildings, primarily in central cities and older neighborhoods, and extended the regular investment tax credit to older buildings for the purpose of promoting stability and economic vitality in deteriorating areas. No special credit was provided for certified historic structures, although the credit was made available for rehabilitation of such structures only if the Secretary of the Interior certified the rehabilitation as appropriate.

In 1981, Congress enacted the Accelerated Cost Recovery System (ACRS), and noted that ACRS had the unintended effect of reducing the relative attractiveness of the original (ten percent) credit for rehabilitating older buildings. Accordingly, Congress replaced the original rehabilitation credit with the three-tier credit contained in current law. The three-tier system had the effect of (1) increasing the amount of the credit available for all qualified buildings, (2) further increasing the credit for buildings more than 30 years old, and (3) providing a special increased credit for certified historic structures.

The current rehabilitation tax credit is flawed in several respects. First, the credits are embedded in a complicated matrix of tax rules which, taken as a whole, result in widely varying after-tax returns for investments in different types of assets. There is no evidence that the combined tax benefits granted to rehabilitators of older buildings, when compared to the tax benefits available to constructors or rehabilitators of newer buildings, are an appropriate incentive for investment in older buildings. Moreover, since the amount of the credit for any qualified rehabilitation is generally a function only of (1) the age of the existing structure, and (2) the cost of the rehabilitation, the incentive effects of the credit are not limited to investment in deteriorating areas, as opposed to modernization of older structures in stable areas.

In addition, the 25 percent credit for certified historic structures is effectively administered by an agency without budgetary responsibility for the revenue cost. The Secretary of the Interior is given sole authority to determine whether a structure meets the requirements for the credit, but the subsidy is not included in the Interior Department's budget. Thus, in determining the availability of the credit, the sole reviewing agency has no direct incentive to compare probable costs and benefits.

Proposal

The rehabilitation credit would be repealed.

Effective Date

Repeal would be effective for expenditures incurred on or after January 1, 1986. An exception would be provided for expenditures incurred pursuant to binding commitments entered into prior to the introduction of this proposal in legislation. Expenditures incurred, other than pursuant to binding commitments, after the effective date would be aggregated with expenditures incurred prior to the effective date for purposes of determining whether the earlier expenditures were incurred in connection with a "substantial" rehabilitation.

Analysis

In the absence of investment tax credits for rehabilitation expenditures, the full amount of such expenditures would be recovered through normal cost recovery rules. Under a system of economic depreciation, effective tax rates on investment in rehabilitation of older and historic structures would be comparable to effective tax rates on other investments.

REPEAL SPECIAL RULES FOR BOOK, MAGAZINE, AND DISCOUNT COUPON INCOME

General Explanation

Chapter 15.02

Current Law

Magazine, Paperback, and Record Returns. An accrual basis taxpayer that distributes magazines, paperbacks, or sound recordings for resale may elect (irrevocably) to exclude from gross income for the taxable year certain amounts attributable to the sale of such items if the purchaser fails to resell the items and returns them within a specified period after the end of the taxable year (2-1/2 months in the case of magazines, and 4-1/2 months in the case of paperbacks and recordings). The exclusion applies only if, at the time of sale, the taxpayer has a legal obligation to adjust the sales price if the items are not resold, and the exclusion is limited to the amount of price reductions for returns that are actually made within the prescribed periods.

An election to take advantage of this exclusion triggers the application of special transitional adjustment rules designed to prevent the "bunching" of deductions in the first year of the election. In the case of an election relating to magazines, the decrease in income resulting from the bunching of deductions in the first year is spread over a five-year period. In the case of an election relating to paperbacks or records, however, the decrease is placed in a suspense account. Adjustments to this suspense account permit additional exclusions from income in subsequent taxable years only to the extent the taxpayer's adjustments from post-year returns decline over time. In general, the effect of the suspense account is to defer deduction of the transitional adjustment until the taxpayer ceases to be engaged in the trade or business of publishing or distributing paperbacks or records.

Redemptions of Qualified Discount Coupons. An accrual basis taxpayer that issues discount coupons with respect to merchandise marketed by unrelated retailers may irrevocably elect to deduct in the taxable year the cost of redeeming qualified coupons that are returned within six months after the end of the taxable year. A shorter period may be used at the taxpayer's election.

In the case of an election under this provision, the decrease in income resulting from the "bunching" of deductions in the first year is not allowed but is placed in a suspense account. Adjustments to this suspense account permit additional deductions in subsequent taxable years only to the extent the taxpayer's qualified discount coupon redemptions decline over time. If such redemptions do not decline, the suspended amounts may be deducted only when the taxpayer ceases to be engaged in the business.

EXTEND AND MODIFY RESEARCH AND EXPERIMENTATION CREDIT

General Explanation

Chapter 15.03

Current Law

A 25 percent nonrefundable tax credit is allowed for the portion of a taxpayer's qualified research expenses which is equal to the lesser of (1) the excess of such expenses in the current year over the average amount of such expenses for the prior three years or (2) 50 percent of qualified research expenses in the current year. Special rules apply to aggregate qualified research expenses of certain related persons to ensure that the credit is available only for real increases in qualified research expenditures.

"Qualified research expenses" generally include only research and development costs in the experimental or laboratory sense. Qualified research expenses that are eligible for the credit include (1) expenses paid or incurred for qualified research conducted directly by the taxpayer, (2) 65 percent of any amounts paid or incurred to another person for qualified research (i.e., "contract research" expenses), and (3) in the case of corporate taxpayers, 65 percent of any amounts contributed to universities and other qualifying organizations for the conduct of basic research.

The credit is available only for research expenses paid or incurred in connection with an ongoing trade or business of the taxpayer. Employee wages are treated as qualified research expenses to the extent paid to an employee for engaging in (1) the actual conduct of qualified research, (2) the immediate supervision of qualified research activities, or (3) the direct support of such activities. Payments for supplies used in the conduct of qualified research and amounts paid for the right to use personal property in the conduct of qualified research also constitute qualified research expenses.

Expenses of (1) research conducted outside the United States, (2) research in the social sciences and humanities, and (3) funded research are specifically excluded from qualified research expenses eligible for the credit.

Credits that are not used in a taxable year may be carried back three years and forward 15 years. The credit will not be available for expenses paid or incurred after December 31, 1985.

Reasons For Change

The existing credit for research and experimentation activities is intended to create an incentive for technological innovation. The benefit to the country from such innovation is unquestioned, and there

Reasons for Change

The primary purpose of the special provisions for magazine, paperback, and record returns, and redemptions of qualified discount coupons, was to enable taxpayers to conform their tax accounting to their financial accounting. In both cases, the exclusion or deduction is designed to approximate decreases in adjusted gross income that would have accrued at the end of the taxable year if the amount of the taxpayer's price-adjustment or redemption obligation were known at that time.

On the other hand, there is a general standard for accrual of liabilities in the taxable year -- occurrence of all events sufficient to establish the existence and amount of the liability. The cases covered by the current rules do not satisfy this standard, since the events establishing the taxpayer's liability for the adjustment -- return of magazines, paperbacks, or records, or presentment of coupons -- have not occurred as of the end of the year.

Both provisions lead to a mismatching of income and deductions and an understatement of total income in the economy. Redemptions of discount coupons in year two are deducted by the issuer in year one even though the retailer may not include the redemptions in income until year two. Similarly, refunds for returns of magazines, paperbacks, and records are deducted in year one by the publisher even though the retailer may not include the refunds in income until year two. The mismatching results in a one-year deferral of taxation of the income, a deferral that increases annually in the case of new and growing firms.

Repeal of these rules would also simplify the tax code and would make it unnecessary to determine the correctness of taxpayers' claims that post-year price adjustments and redemptions are made pursuant to obligations or coupons that were outstanding prior to the end of the taxable year.

Proposal

The elections (a) to exclude from income certain adjustments relating to magazines, paperbacks, and record returns, and (b) to deduct costs of redeeming qualified discount coupons, would be repealed.

Effective Date

The repeal would be effective for taxable years ending on or after January 1, 1986. Affected taxpayers would be permitted to deduct the balances of their suspense accounts or suspended amounts in the first taxable year in which the proposal is effective.

Analysis

Taxpayers adversely affected by repeal of these special accounting rules would gain a compensating benefit from the proposed general reductions in tax rates.

are reasonable grounds for believing that market rewards to those who take the risks of research and experimentation are not sufficient to support an optimal level of such activity. The credit is intended to reward those engaged in research and experimentation of unproven technologies.

Although the credit for research and experimentation is justified in concept, the existing definition of eligible activities is overly broad. Some taxpayers take the view that the costs of any trial and error procedure are eligible for the credit even though there may be little doubt about the outcome of the procedure.

The definition of qualifying expenses for purposes of the credit should identify clearly those innovative research activities which merit government support. This definition also should incorporate standards that are sufficiently objective to permit taxpayers, in planning their activities, to determine with reasonable certainty whether the credit will be available. A definition that satisfies these two criteria would be more effective in encouraging taxpayers to undertake innovative research and experimental activities.

Proposal

The credit for increases in research and experimentation expenditures would be extended for an additional three years (until December 31, 1988), and the definition of qualified research would be revised to target those research activities likely to result in technological innovations.

Effective Date

The revised definition of qualified research would be effective for expenses paid or incurred after December 31, 1985.

Analysis

The definition of expenses qualifying for the research credit should target private research activities designed to lead to technological innovations in products and production processes. At the same time, the definition must be phrased in terms that permit taxpayers to know with reasonable certainty what research activities qualify for the credit.

A useful definition incorporating both principles is found in the Senate amendment to H.R. 4170 (enacted as the "Tax Reform Act of 1984"). Although the conference committee agreed to defer consideration of the research credit, the Senate definition targets technological innovation and provides taxpayers with relatively objective rules.

The Senate definition focuses on new or technologically improved products and processes and provides that research qualifies for the credit only if it relates to a process of experimentation encompassing the evaluation of alternatives that involve a serious degree of uncertainty as to whether the desired result can be achieved. This requirement is designed to ensure that the credit is available only for research activities intended to lead to technological innovation. In addition, the Senate definition excludes a number of activities, such as reverse engineering and debugging, that, by their nature, will not result in technological innovation.

Further refinements in the Senate definition, such as identifying additional exclusions from the scope of qualifying research, may be appropriate to ensure that the credit does not subsidize private research activities that are not innovative. In addition, the revenue loss resulting from the extension of the credit must be considered in redefining the scope of qualifying expenses.

Finally, the proposal to extend the research credit does not include support for other proposals traditionally associated with the credit, such as a separate credit for contributions to fund basic university research or an enhanced charitable deduction for contributions of scientific equipment to universities.

REPEAL MERCHANT MARINE CAPITAL CONSTRUCTION FUND EXCLUSION

General Explanation

Chapter 15.04

Current Law

The Merchant Marine Act provides special tax treatment for U.S. citizens and domestic corporations owning or leasing certain eligible vessels operated in the foreign or domestic commerce of the United States or in U.S. fisheries. A vessel qualifies as an eligible vessel only if it was constructed or reconstructed in the United States and is documented under the laws of the United States.

In general, a taxpayer that qualifies for this treatment receives a deduction for amounts deposited in a capital construction fund pursuant to an agreement with the Secretary of Transportation or, in the case of U.S. fisheries, the Secretary of Commerce. The deductible amount is limited to the portion of the taxable income of the owner or lessee that is attributable to the qualified operation of the vessel covered by the agreement. In addition, nondeductible deposits may be made up to the amount of depreciation on such vessel for the year. Earnings on all amounts in the fund are exempt from federal income tax liability.

The tax consequences of a withdrawal from such a fund are determined by reference to three accounts. The capital account represents deposits that were not deductible as well as the fund's tax-exempt income (that is, income exempt from tax without regard to the fund's special exemption). The capital gain account represents accumulated net long-term capital gain income of the fund. The ordinary income account represents deductible deposits and accumulated taxable income of the fund (that is, income that would have been taxable if the fund were not exempt).

The tax treatment of a withdrawal depends on whether it is "qualified." A withdrawal is qualified if used to acquire, construct, or reconstruct eligible vessels (or barges and containers which are part of the complement of such vessels) in accordance with the terms of the applicable agreement, or to repay principal on debt incurred with respect to such acquisition, construction, or reconstruction.

A qualified withdrawal is not currently taxable, and is deemed to come first out of the capital account, then out of the capital gain account, and finally out of the ordinary income account (after the other accounts have been exhausted). Amounts withdrawn from the ordinary income or capital gain accounts reduce the taxpayer's basis in its investment in the vessels (only in part in the case of capital gain account withdrawals). A taxpayer may, however, compute its investment tax credit by including at least one-half of its qualified withdrawals in basis. Accordingly, the taxpayer is entitled to at least a partial investment tax credit on investments made with fund withdrawals, even though its basis attributable to withdrawals is zero for purposes of computing depreciation. A qualified withdrawal out of the ordinary income or capital gain account made to retire debt requires a reduction in the basis of vessels, barges, and containers owned by the person maintaining the fund.

Nonqualified withdrawals are deemed to come first out of the ordinary income account, then out of the capital gain account, and finally out of the capital account. A nonqualified withdrawal treated as made out of the ordinary income account must be included in taxable income. To the extent the withdrawal comes out of the capital gain account it is taxed as long-term capital gain; a withdrawal out of the capital account is not taxable. Interest on the tax liability attributable to the withdrawal is payable from the time for payment of tax for the year in which the item was deposited into the fund.

Reasons for Change

The current rules for taxation of merchant marine capital construction funds are a gross departure from generally applicable principles of taxation. The special rules generally exempt from tax earnings on deposits in such funds. Moreover, they permit an eligible taxpayer to expense capital investments made with fund withdrawals as well as claim an investment tax credit on an asset in which it has a zero basis.

The special tax treatment of capital construction funds originated, along with a direct appropriations program, to assure an adequate supply of shipping in the event of war. It was thus feared that because of comparative shipbuilding and operating cost disadvantages, peacetime demand for U.S.-flag vessels would not reflect possible wartime needs.

A national security justification for subsidies of U.S. maritime construction is today very much in doubt. U.S. citizens own or control large numbers of ships registered in Panama, Liberia, and Honduras that would be available to the United States in an emergency, and most U.S. allies possess substantial fleets of oceangoing cargo ships that would be available in any common emergency. Largely for this reason, direct appropriations for maritime construction (the construction differential and operating differential subsidies) are being phased out. A similar fate is appropriate for the special tax rules applicable to capital construction funds.

Proposal

The rules providing special tax treatment for capital construction funds would be repealed.

Effective Date

Earnings on assets in capital construction funds attributable to the period after January 1, 1986, would be subject to tax. No further tax-free contributions could be made after the date legislation is introduced. Any withdrawals from a fund after January 1, 1986, would be treated as nonqualified withdrawals, but would be treated as coming first out of the capital account, then the capital gain account, and finally the ordinary income account. Any amounts remaining in a capital construction fund on January 1, 1996, would be treated as withdrawn at that time.

Analysis

Repeal of the special tax treatment for capital construction funds would promote neutrality by ensuring that capital investments are made only when justified by economic rather than tax considerations.

REPEAL POSSESSIONS TAX CREDIT

General Explanation

Chapter 15.05

Current Law

Section 936 provides a special credit for certain income of qualifying corporations operating in Puerto Rico and possessions of the United States other than the Virgin Islands. A section 936 corporation is generally subject to tax on its worldwide income in a manner similar to any other U.S. corporation, but a full credit is given for the U.S. tax on the business and qualified investment income from the possessions regardless of whether any tax is paid to the government of the possessions. The effect of this treatment is to exempt from tax the income from business activities and qualified investments in the possessions and the income from disposition of a possessions business. (Rules having similar effect, but through a different mechanism, for the Virgin Islands are contained in section 934(b)). All other income of section 936 corporations is taxed currently with the usual credit for foreign taxes paid on foreign source income. To avoid a double credit against U.S. taxes, no credit is allowed under section 901 for taxes paid on income subject to the section 936 credit, and no deduction is allowed for such tax.

Any domestic corporation which elects to be a section 936 corporation can receive the section 936 credit if it satisfies two conditions. First, 80 percent or more of its gross income for the three year period immediately preceding the close of the taxable year must be from sources within a possession (or possessions). Second, for tax years beginning after 1984 at least 65 percent of its income for that period must be from the active conduct of a trade or business within a possession (or possessions).

Puerto Rico has complemented the section 936 credit with incentives of its own. Puerto Rico grants tax exemptions of up to 90 percent for income of certain approved enterprises for specified periods of time (generally 10 to 25 years). In addition, Puerto Rico exempts from tax certain passive income. The combination of the section 936 credit and the Puerto Rican incentives means that qualifying corporations are essentially exempt from tax on their Puerto Rico source income.

The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) made two changes designed to reduce the revenue cost due to (a) the attempted allocation of intangible income to possessions in order to claim exemption for such income, and (b) the exemption of passive income. The problem of intangible income was addressed by adding a very complex set of allocation rules to section 936 for tax years beginning after 1982. The revenue cost of exempting passive income was addressed by increasing the active trade or business percentage from 50 percent in 1982 to 65 percent in 1985.

The income tax systems in effect in the U.S. territories basically mirror the Internal Revenue Code but with special exceptions and provisions that vary from one territory to another.

Reasons for Change

Independently of the section 936 credit, a corporation can generally achieve indefinite deferral of U.S. tax on possessions business source income, under the rules applicable to the income of foreign corporations, simply by incorporating in a possession. The section 936 credit produces an additional benefit in the form of a negative effective tax rate on possessions source income. This is accomplished by providing income allocation rules which, in many cases, permit shifting income from the U.S. parent to a section 936 corporation. This distorts investment decisions without necessarily transferring real economic activity to the possessions.

The stated purpose of section 936 is to "assist the U.S. possessions in obtaining employment-producing investments by U.S. corporations". Despite the fact that the inflation-corrected tax-exempt income of possessions corporations has more than doubled since 1972, employment levels (both overall and in the manufacturing sector) have been flat. The average tax benefit per employee for all section 936 corporations was more than $22,000 in 1982. In that year the average wage of possessions corporations' employees was $14,210. Fourteen corporations received tax benefits in excess of $100,000 per employee.

The TEFRA changes were designed to reduce the revenue cost of this program. There remains, however, no direct incentive under current law to increase employment in the possessions. As a result, we have a system which is one of the most complex in the tax law, expensive, difficult to administer and yet has not been effective in creating jobs in the possessions.

The territorial tax systems are replete with inconsistencies and ambiguities which have made it difficult to coordinate the Federal and territorial income taxes, and make them susceptible to abuse. They also result in unequal tax burdens on comparable incomes in the different territories.

Proposal

The Treasury Department does not believe that there should be a permanent tax subsidy for operations in the possessions. As noted above, the general rules for taxation of foreign corporations provide for deferral of U.S. tax on the income of such corporations until the income is repatriated. However, it is important to minimize the disruption caused by changes in the tax law. Therefore, the current system will be replaced with a more cost-effective approach which would then be phased out after several years.

The current section 936 credit will be replaced by a wage credit. The amount of the credit will be a fixed dollar amount per hour worked. The credit will be available for all persons employed in the possessions by an establishment engaged in manufacturing. The credit will not be refundable but may be carried to any other taxable year in the period 1987-2000. The deduction for wages will be reduced by the amount of the credit. A similar change will be made for corporations receiving the benefits of section 934(b).

The wage credit will replace the existing credit for taxable years beginning on or after January 1, 1987. It will be 60 percent of the minimum wage for a six year period, 1987 through 1992 and then will be phased out in equal installments over the next six years:

Year	Credit as percent of minimum wage
1987-1992	60
1993	50
1994	40
1995	30
1996	20
1997	10
1998 and subsequent	0

The territorial income tax systems will be rationalized to make them simpler and fairer and to reduce the potential for abuse.

Analysis

The current system is complex, expensive and ineffective. The rules for determining possessions source income are among the most complex in the tax law. The average revenue cost per job was more than 150 percent of the average total compensation of employees of section 936 corporations. Despite this, total employment has been flat. The proposal will simplify the law considerably and will provide a more direct and more cost-effective incentive to create jobs in the possessions.

Since the tax benefits received by some current section 936 corporations will be substantially reduced under a wage credit, these corporations, primarily in the pharmaceutical and electronics industries, may decide to restructure or even close their operations in the possessions. However, the proposal should attract more labor intensive industries.

CHAPTER 16

OTHER CURTAILMENT OF TAX SHELTERS

Current rules limiting the deduction of investment interest are inadequate to curtail tax shelter abuses. This Chapter proposes a comprehensive limitation on the deduction of nonbusiness interest. In addition, the special exceptions to the at-risk limitations for certain leasing and real estate activities would be repealed, so that the at-risk rules would apply uniformly to all activities.

LIMIT INTEREST DEDUCTIONS

General Explanation

Chapter 16.01

Current Law

In general, interest paid or incurred on indebtedness is fully deductible from income. This general rule is subject to exceptions for interest on indebtedness incurred to generate certain tax-preferred income. Thus, for taxpayers other than certain financial institutions, no deduction is allowed for interest on indebtedness incurred to purchase or carry obligations which generate tax-exempt income. In addition, for noncorporate taxpayers, interest on debt incurred to acquire or carry investment property ("investment interest") is deductible only to the extent of the sum of (i) $10,000 ($5,000 for married persons filing separately), (ii) "net investment income," and (iii) certain deductions attributable to net-leased property. Amounts disallowed under this limitation for a taxable year are carried forward and treated as investment interest in the succeeding taxable year.

Interest on debt incurred to acquire or carry personal-use property or business property is ordinarily deductible currently, even if that property does not produce taxable income or is likely to appreciate substantially (resulting in deferred capital gains). (See Ch. 10.01 for a discussion of circumstances in which interest costs must be capitalized when incurred in connection with certain production or manufacturing activities.)

Reasons for Change

Clear reflection of income for tax purposes requires that the costs of generating income be matched with the income actually earned. If a current deduction is allowed for the cost of producing income that is exempt from tax or includible in income on a deferred basis, the current deduction will offset other taxable income and thus eliminate or defer tax. Such "tax arbitrage" occurs, for example, when an investor deducts interest on indebtedness incurred to acquire or carry assets that yield tax-exempt income such as personal-use property or assets held in an Individual Retirement Account. It also occurs, though with less predictability, where indebtedness is incurred to acquire or carry interests in business property that experiences real appreciation over time.

Current law permits taxpayers to deduct the interest costs of generating certain tax-exempt or tax-deferred income. Although interest incurred to acquire or carry tax-exempt bonds is nondeductible, interest incurred to produce analogous forms of tax-preferred income is deductible without limitation. Thus, "consumer interest," i.e., interest incurred to acquire personal assets, such as a car or vacation home, is fully deductible, even though such assets do not generate taxable income. Similarly, current law limits the deductibility of "investment interest," but interest incurred in a trade or business is fully deductible, even if the investor is not actively engaged in the management of the business and much of the return from the business is expected to be in the form of deferred capital gains. This current deductibility of interest is an important feature of real estate tax shelter investments structured as limited partnerships.

The unlimited deduction for consumer and "passive" business interest also undermines existing limitations on investment interest and interest incurred to acquire tax-exempt bonds. Since money is fungible, the identification required under current law of the purpose for which indebtedness is incurred is difficult at best. The general deductibility of all consumer and business interest complicates the task of determining whether debt was incurred for a nondeductible purpose.

Proposal

Interest subject to the current investment interest limitation would be expanded to include: (a) all interest not incurred in connection with a trade or business (other than interest on debt secured by the taxpayer's principal residence, to the extent such debt does not exceed the fair market value of the residence), (b) the taxpayer's share of all interest expense of S corporations (other than S corporations in which the taxpayer actively participates in management), and (c) the taxpayer's distributive share of all interest expense of limited partnerships in which the taxpayer is a limited partner. Interest on indebtedness incurred to carry or acquire business rental property used by the taxpayer for personal purposes for part of a taxable year would generally be treated as business interest (and thus not subject to limitation) in the same proportion that the number of days the property is rented at a fair rental bears to the number of days in the taxable year.

Interest subject to the limitation would be deductible only to the extent of the sum of (a) $5,000 ($2,500 in the case of a married person filing a separate return), and (b) the taxpayer's net investment income. In general, net investment income for this purpose would have the same meaning as under current law, except that it would include the taxpayer's share of all income of S corporations not managed by the taxpayer, and the taxpayer's distributive share of all income of limited partnerships in which the taxpayer is a limited partner. Any interest deduction disallowed for the taxable year under this limitation would be treated as investment interest expense for the succeeding taxable year.

In general, interest income and expense would be adjusted by application of the fractional exclusion rate (see Ch. 9.03) prior to application of the investment interest limitation. Suspended interest deductible in a succeeding taxable year would not be subject to further adjustment by the fractional exclusion rate. If interest subject to the limitation includes both itemized and nonitemized interest expense deductions, suspended interest would first reduce the current deduction for nonitemized interest expense to the extent thereof, and the current deduction for itemized interest expense to the extent of any excess. Suspended interest deductions subsequently allowed would first be treated as itemized interest expense, to the extent of suspended itemized interest deductions, and nonitemized interest expense to the extent of the excess.

Effective Date

The proposal would be effective for interest expense paid or incurred in taxable years beginning on or after January 1, 1986. The expanded limitation would be phased in so that for taxable years beginning before January 1, 1988, interest subject to limitation would be deductible to the extent of $10,000 plus net investment income.

Analysis

Because the expanded limitation on interest deductions would not apply to mortgage interest deductions on the taxpayer's principal residence nor to the first $5,000 of any additional interest expense, the vast majority of taxpayers would not be affected by the proposal. Interest expenses attributable to a trade or business in which the taxpayer actively participates also would not be subject to the limitation. Thus, sole proprietors, owner-operators of farms, general partners, and shareholder-managers of S corporations would continue to treat their business expenses in the same manner as under current law. However, taxpayers with substantial tax shelter interest expense would be prevented, in many cases, from using that interest expense to offset business and employment income.

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EXTEND AT-RISK LIMITATION TO ALL ACTIVITIES

General Explanation

Chapter 16.02

Current Law

In general, current law limits the loss a taxpayer may deduct from an investment to the amount the taxpayer has at-risk with respect to such investment. This "at-risk" limitation on deductible losses applies to individuals and to certain closely held corporations, and is applied on an "activity-by-activity" basis.

For purposes of the at-risk rules, a taxpayer is generally at-risk in an activity to the extent that the taxpayer has contributed money or property (to the extent of its basis) to the activity, or is personally liable to repay borrowed funds used in the activity. A taxpayer is not considered to be at-risk with respect to amounts protected against loss through nonrecourse financing, guarantees and stop loss or similar arrangements. Losses which are disallowed for a taxable year under the at-risk rules are carried forward indefinitely and are allowed in a succeeding taxable year to the extent that the taxpayer increases the amount at-risk in the activity giving rise to the losses.

The at-risk rules apply to all activities other than (1) real estate activities and (2) certain equipment leasing activities conducted by closely held corporations. Accordingly, an investor in real estate (or a closely held corporation engaging in certain equipment leasing activities) may deduct losses from the investment for tax purposes that exceed the investor's maximum possible economic loss from the investment.

Reasons for Change

The at-risk rules of current law reflect the fact that, as an economic matter, an investor cannot lose more than the amount that he or she has directly invested plus any additional amount for which the investor is liable. This principle is no less true for investments in real estate or equipment leasing than it is for the activities to which the current at-risk rules apply.

The exclusion of real estate and equipment leasing from the at-risk rules allows taxpayers investing in such activities to offset taxable income with tax losses that will never be matched by economic losses. The allowance of such noneconomic losses for tax purposes is a necessary basis for many tax shelter investments. Front-loaded tax losses that have no economic basis permit the investor to shelter other income from tax. The resulting deferral of tax liability guarantees a return to the investor that may make an otherwise noneconomic investment plausible. Tax-driven noneconomic investment activity diverts capital from more productive uses, causes overinvestment in the tax-preferred activities and thus distorts prices and capital costs throughout the economy.

Tax shelter activity also invites disrespect for the tax law. Whether legally justified or not, the use of tax shelters by high-income, well advised taxpayers is viewed with confusion and skepticism by taxpayers. These perceptions undermine the voluntary compliance that is crucial to the income tax system.

Proposal

The at-risk rules would be extended to all investment and business activities, including real estate and equipment leasing activities. The at-risk rules would continue to be applicable only to individuals and certain closely held corporations.

Effective Date

The proposal would be effective for losses attributable to property acquired after the date on which the proposal is introduced as legislation, unless acquired pursuant to a binding contract entered into prior to that date.

Analysis

Extending the at-risk rules to all activities would not inhibit the leveraged acquisition of properties expected to yield a market rate of return. The proposal, however, would require that investors in real estate and leasing activities evaluate the economic risk of loss associated with investments in those activities as well as their tax benefits and income potential. The proposal thus would leave real estate and equipment leasing investments subject to the same market discipline as currently applies to investments generally. The enhanced neutrality among investment alternatives would improve resource allocation and reduce overinvestment in these activities that are currently tax preferred. This, in turn, should lead to overall productivity gains.

It is possible that the laws of some States that preclude the use of recourse debt in connection with the acquisition of certain real estate could prevent certain investors in those States from receiving full tax benefits from leveraged real estate investments. It is anticipated that any such States would act quickly to permit business investments in real estate to employ recourse indebtedness.

CHAPTER 17

RETIREMENT SAVINGS

The Treasury Department proposals would maintain the current tax-favored treatment of retirement saving, and would expand the tax-deductible amounts that may be placed into individual retirement accounts (IRAs). Cash or deferred arrangements, which effectively allow employees to avoid limits on IRAs, would be repealed. Other revisions would provide more consistent treatment of various types of retirement plans. Uniform rules, including an excise tax on premature distributions, would govern distributions from various types of plans, and more uniform contribution limits would be established. The overall limit on non-top-heavy defined benefit and defined contribution plans would be eliminated and an excise tax would be imposed on annual distributions in excess of specified limits. To preclude employers from receiving unintended tax benefits by overfunding plans, a ten percent additional tax would be imposed on plan funds reverting to an employer upon plan termination. Finally, qualified pension plans would be permitted to use benefits forfeited by a separated employee to increase the benefits of other employees.

INCREASE INDIVIDUAL RETIREMENT ACCOUNT (IRA) LIMITS

General Explanation

Chapter 17.01

Current Law

An individual generally is permitted to deduct annual contributions to an individual retirement account or annuity (IRA) up to the lesser of $2,000 or 100 percent of the individual's annual compensation. Thus, if a married individual and his or her spouse each receive compensation during a year, each may make separate deductible contributions to his or her own IRA up to the lesser of $2,000 or 100 percent of compensation.

If an individual receives no compensation during a year, the individual generally is not allowed to make a deductible IRA contribution for such year. Special "spousal IRA" limits, however, provide that if a married individual's spouse earns no compensation during a year and if the married couple files a joint return for the year, the individual may deduct annual IRA contributions up to the lesser of $2,250 or 100 percent of the individual's annual compensation. The contributions may be allocated in any fashion between the individual's IRA and the nonearning spouse's IRA, except that no more than $2,000 may be contributed to either IRA.

The special spousal IRA maximum limit of $2,250 is not available if the married individual's spouse has compensation income during the year. Thus, if a husband and wife each have compensation income, each is subject separately to the $2,000 and 100 percent of compensation limits on deductible contributions. As a consequence of this rule, a married couple with a nonearning spouse is permitted to make larger total deductible IRA contributions than a married couple with a spouse who has compensation income of less than $250.

Reasons for Change

The tax benefits applicable to IRAs are intended to encourage individuals to make adequate provision for their retirement security. Savings for this purpose also contribute to the formation of investment capital needed for economic growth. For many individuals, including individuals who are covered by employer-maintained retirement plans, IRAs are an important element in an overall strategy to provide for retirement security. The use of IRAs for retirement saving should thus not only be encouraged, but made available on a broad and consistent basis.

The existing limitations on IRA contributions are illogical and inequitable as applied to married couples. The relatively minor allowances for a spousal IRA fail to recognize the important economic contributions made by nonearning spouses. Moreover, they are inconsistent with other rules of current law under which married couples are treated as an economic and taxpaying unit. Thus, a husband and wife that each earn $10,000 can make aggregate IRA contributions of $4,000 under current law. A couple with the same joint income of $20,000, all of it earned by one spouse, can make aggregate IRA contributions of only $2,250. A third couple, also with $20,000 of joint income, but with one spouse earning only $200, is limited even further to a $2,200 aggregate IRA contribution. These disparate results are inconsistent with both the retirement savings policy reflected in IRAs and with general tax principles requiring similar treatment of similarly situated taxpayers.

Proposals

The dollar limit on the deductible IRA contributions that may be made by an individual would be increased from $2,000 to $2,500.

A married individual filing a joint return, including an individual with no annual compensation, would be permitted to take into account his or her spouse's compensation (less the deductible IRA contribution made by such spouse) in determining the deduction limit for such individual. Thus, married couples with aggregate compensation of $5,000 or more would be entitled to the same $5,000 aggregate IRA contribution ($2,500 apiece) regardless of how much of the aggregate compensation was generated by either spouse.

Effective Date

The increased dollar limit on IRA contributions and the spousal compensation rule for married individuals would apply to taxable years beginning on or after January 1, 1986.

Analysis

Increasing the IRA deduction limits would encourage taxpayers to set aside additional amounts in long-term savings. This would not only enhance individual retirement security, but should also contribute to increased capital formation and productivity.

UNIFY RULES FOR QUALIFIED RETIREMENT PLAN DISTRIBUTIONS

General Explanation

Chapter 17.02

Current Law

Current law provides tax-favored treatment with respect to funds set aside under any of several employer-sponsored or individual plans providing for deferred compensation or retirement savings. Such tax-favored plans include qualified profit-sharing, stock bonus, and pension plans (section 401(a)), qualified annuity plans (section 403(a)), tax-sheltered annuities and custodial accounts (section 403(b)), individual retirement accounts and annuities (section 408(a)&(b)), and simplified employee pensions (section 408(k)). Although these tax-favored retirement plans are related in concept and purpose, distributions from the plans are subject to differing requirements and may result in significantly different tax consequences to individual recipients.

Minimum Distribution Requirements. Tax-favored retirement plans are subject to certain minimum requirements concerning the timing and amount of distributions. Qualified profit-sharing, stock bonus, pension, and annuity plans must generally commence distributions no later than the April 15 following the year in which the employee attains age 70-1/2, or, if later, the year in which the employee retires. Benefits thereafter must be distributed under a minimum distribution schedule. Additional rules require minimum annual distributions where the employee dies before benefit distributions have commenced or have been completed. A qualified plan failing to satisfy the minimum distribution rules with respect to a participant may lose its tax-favored status.

Individual retirement accounts (IRAs) and simplified employee pensions (SEPs) must commence distributions no later than the year in which the IRA or SEP owner attains age 70-1/2, without regard to whether such owner has retired. Thereafter, benefits must be distributed under lifetime and after-death distribution schedules similar to those for qualified plans. An IRA or SEP that fails to satisfy the minimum distribution rules does not lose its tax-favored status. Instead, the payee is subject to an excise tax of 50 percent of the amount by which the required distribution exceeds the amount actually distributed.

Benefits provided through tax-sheltered annuities and custodial accounts are not subject to minimum distribution rules for the period during which the original holder of the annuity or custodial account remains alive. If, however, the holder dies before the entire interest in the annuity or account is distributed, distribution rules based on the after-death rules for qualified plans must be satisfied.

Early Distributions. *In general, amounts distributed from* tax-favored retirement plans are fully taxable to the recipient at the time of distribution. There are a variety of exceptions to this general rule, however, under which certain distributions incur additional taxes and certain others receive more favorable tax treatment than ordinary distributions.

Distributions from an IRA or SEP before the IRA or SEP owner dies, becomes disabled, or attains age 59-1/2 generally are subject to a ten percent additional tax. Similar distributions from a qualified profit-sharing, stock bonus, pension, or annuity plan are subject to an additional tax only in the case of employees owning more than five percent of the employer. Early distributions from tax-sheltered annuities are not subject to any additional tax. Early distributions from tax-sheltered custodial accounts are generally prohibited absent financial hardship or disability.

Lump Sum Distributions. Preferential tax treatment is currently available for certain lump sum distributions from a qualified profit-sharing, stock bonus, pension or annuity plan. Under a special averaging rule, the tax liability on a lump sum distribution is determined as though the individual received the distribution ratably over ten years. In addition, the portion of a lump sum distribution attributable to plan participation before 1974 may be taxed at capital gain rather than ordinary income rates. Whether a lump sum distribution qualifies for favorable treatment is determined under an extensive set of rules, based in part on the employee's age, employment status and years of participation in the plan. Favorable lump sum treatment is not available for distributions from IRAs, SEPs, or tax-sheltered annuities or custodial accounts.

Employer Securities. Current law also provides preferential tax treatment for net unrealized appreciation on employer securities included in a lump sum distribution from a qualified profit-sharing, stock bonus, or pension plan. Such appreciation is not included in income at the time of distribution, but instead is taxable upon subsequent disposition of the securities, ordinarily at capital gain rates. If the distribution is not a lump sum distribution, only the unrealized appreciation on employer securities purchased with employee contributions qualifies for the special treatment. Unrealized appreciation on plan distributions of securities other than employer securities is fully taxable upon distribution.

Basis Recovery. Tax-favored retirement plans are also subject to special rules for the recovery of contributions by the employee that were previously subject to tax. Outside the area of tax-favored retirement plans, amounts not received as annuities before the annuity starting date are generally treated first as a taxable distribution and second as a tax-free recovery of the employee's contributions. This basis recovery rule is reversed, however, for non-annuity distributions from qualified profit-sharing, stock bonus, pension, and annuity plans and tax-sheltered annuities and custodial accounts, so that distributions are treated first as a tax-free recovery of employee contributions.

Tax-favored retirement plans are also granted special treatment for amounts received as annuities after the annuity starting date. Under general basis recovery rules, employee contributions are recovered tax-free on a pro rata basis, in accordance with an exclusion ratio based on the employee's life expectancy at the time distributions commence. An employee's after-tax investment in a tax-favored plan, however, is recovered prior to any taxable distributions, provided that the aggregate amount to be distributed during the first three years exceeds such after-tax investment.

Rollovers. Distributions from a tax-favored retirement plan are not subject to taxation to the extent rolled over to another retirement plan. A complex series of rules governs the extent to which distributions from particular plans may be rolled over as well as the type of plans to which rollovers may be made. In general, these rules are designed to prevent individuals from avoiding restrictions applicable to certain plans by shifting benefits to a plan that is free of the restrictions.

Constructive Receipt. In general, benefits under tax-favored plans are taxable when received. For most plans, receipt occurs for tax purposes only when benefits are actually distributed. The doctrine of constructive receipt is applied, however, to benefits under tax-sheltered annuities and custodial accounts, which may be treated as received either when actually distributed or when made available to the individual. As a consequence, benefits in such plans may be taxable prior to their actual distribution.

Reasons for Change

The current rules for distributions from tax-favored retirement plans are burdensomely complex for taxpayers and inconsistent in their treatment of similarly situated individuals. The current rules also undercut the basic rationale for tax-favored plans, which is the encouragement of savings for retirement.

Uniform Treatment of Distributions. The various tax-favored retirement plans are important components of a general policy to enhance individual retirement security. The current absence of uniformity in the treatment of such plans creates significant disparities among individuals based on the type of plans to which the individuals happen to have access. Uniform rules would eliminate such disparities and also reduce the complexity of the existing rules governing plan distributions. Existing differences in the tax treatment of plan distributions give tax considerations undue influence over an individual's choice of retirement plans. Moreover, they require individuals either to master a complex set of rules or to seek professional advice. In too many cases they may result in a loss of possible benefits. Uniform rules would have the additional advantage of making unnecessary the current restrictions on the shifting of benefits from one plan to another.

The tax-favored status of retirement plans is intended to enable individuals to replace compensation that terminates with retirement. Minimum distribution rules support this rationale by limiting the extent to which tax-deferral on retirement savings can be extended beyond the individual's retirement. Given the purpose of minimum distribution rules, they should apply to all retirement plans receiving tax-favored treatment.

Uniform sanctions should also apply to violations of minimum distribution rules. The sanction of disqualification, however, is too onerous for a plan's failure to satisfy the highly technical requirements. Disqualification may result in adverse tax consequences to all plan participants, even though plan administration generally is outside the control of the participants and the failure may have occurred with respect to only a single participant. Plan disqualification procedures also impose a significant administrative burden on the Internal Revenue Service.

Encourage Retirement Savings. The current favorable treatment of certain plan distributions undercuts retirement saving by encouraging lump sum or early withdrawals. The special basis recovery rules for certain distributions permit accelerated tax-free recovery of employee contributions. This reduces the tax cost of early withdrawals, and permits employees to use tax-favored plans as short-term savings accounts rather than as retirement savings vehicles. The rules permitting deferral of tax on unrealized gain in distributions of employer securities also reduce the tax cost of such withdrawals.

The special ten-year averaging and capital gain provisions for certain lump sum distributions encourage such distributions and thus are inconsistent with the policy to provide individuals with income throughout the entire period of retirement. The original purpose of the capital gain and ten-year averaging provisions was to mitigate the effect of the progressive tax structure on individuals receiving all of their benefits in a single year. The same purpose is now served, however, by permitting individuals to roll over lump sum distributions into an IRA. This results in the individual being taxed only as amounts are subsequently withdrawn from the IRA.

Proposals

All tax-favored retirement plans, including tax-sheltered annuities and custodial accounts, would be subject to uniform minimum distribution rules governing both lifetime and after-death distributions. Thus, distributions from all tax-favored retirement plans would be required to commence no later than the year in which the individual attains age 70-1/2. Thereafter, both lifetime and after-death distributions would have to conform with minimum payout schedules.

The uniform sanction for failure to satisfy the minimum distribution rules would be a 50 percent excise tax, based on the amount by which the minimum amount required to be distributed exceeds the amount actually distributed. The recipient of the distribution would be primarily liable for payment of the tax, with a right, where applicable, to recover the tax from the plan. The current sanction of disqualification for certain plans would be eliminated.

Tax-sheltered annuity contracts, whether they actually are in the form of an annuity contract issued by an insurance company or a custodial account holding regulated investment company stock, would be subject to the same distribution restrictions currently applicable only to such custodial accounts.

Uniform rules would also govern the tax consequences of plan distributions to individual recipients. Thus, distributions would be subject to tax only upon actual receipt. Current application of the constructive receipt doctrine to tax-sheltered annuities and custodial accounts would be eliminated. In addition, the taxable portion of any distribution from a tax-favored plan would be taxed fully as ordinary income. Thus, the special capital gain and ten-year averaging treatment for lump sum distributions and the deferred inclusion of unrealized appreciation on distributions of employer securities would be eliminated.

In calculating the taxable portion of a plan distribution, the generally applicable basis recovery rules, with certain modifications, would apply. Thus, an amount received before the annuity starting date would be treated, first, as a taxable distribution and, second, as a nontaxable return of basis. Annuity distributions after the annuity starting date would be taxed in accordance with the exclusion ratio established when such distributions commenced. In establishing the exclusion ratio for an individual, standardized recovery periods of five, ten, fifteen, and twenty years would be used in lieu of the individual's actual life expectancy; the recovery period for a particular individual would be the period closest to the individual's life expectancy at the time distributions commence. If distributions cease before the individual recovered his entire basis tax-free, the individual, his estate, or his heirs would be entitled to a deduction for the unrecovered basis. If the individual receives benefits for longer than his recovery period, all additional distributions would be fully taxable.

Early distributions would also be subject to uniform treatment. Thus, the taxable portion of a distribution from any tax-favored retirement plan before the individual's death, disability, or attainment of age 59-1/2 would be subject to an additional tax of 20 percent of such taxable portion. However, if the early distribution is used to pay for college expenses incurred by a dependent or for the purchase of the individual's first principal residence, the rate of the additional tax would be reduced to ten percent. In either case, the additional tax would be nondeductible and could not be offset by any deductions or credits otherwise available to the individual.

Individuals generally would be permitted to make a tax-free rollover of funds, within 60 days, from one tax-favored retirement plan to another. Rollovers and transfers would be limited, however, to prevent individuals from avoiding the minimum distribution rules.

The Treasury Department recognizes that the use of ages 59-1/2 and 70-1/2 as proxies for retirement may subject some distributions being used for retirement purposes to the additional tax and may trigger minimum distributions to individuals who have not retired. Modifications to these conditions would be considered if they could be uniformly applied without serious administrative difficulty.

Effective Date

The new tax rules generally would apply to all distributions from tax-favored retirement plans on or after January 1, 1986. The additional tax on early distributions would apply to all such distributions made after the date this proposal is introduced as legislation.

Analysis

The purpose of the additional tax on early distributions and of the minimum distribution rules is to assure that tax-favored retirement plans are used for retirement purposes. The tax would reduce or eliminate the tax advantages that can be obtained by using tax-favored plans to save for nonretirement purposes, including colleges expenses and the purchase of a residence.

The elimination of capital gain and ten-year averaging treatment for lump sum distributions would not subject individuals using their tax-favored benefits for retirement purposes to significant adverse tax effects. Except to the extent precluded under the minimum distribution rules, an individual receiving a large distribution from a tax-favored plan could still avoid a large tax liability by rolling over some or all of such benefits to an IRA or other qualified plan. This would be consistent with the basic objective of promoting tax-favored distributions over an individual's entire retirement period. In addition, the generally available income averaging provisions (section 1301) would continue to apply to such individuals.

The proposed modifications to the calculation of the exlcusion ratio applicable to distributions after the annuity starting date would assure that an individual (or his estate or heirs) would receive the individual's after-tax investment in the plan without additional tax. Also, the modifications would assure that an individual who outlives his life expectancy would not receive significant amounts in excess of his after-tax investment without tax. Finally, the use of standardized recovery periods would simplify the calculation and application of the exclusion ratio by taxpayers and would ease the administration and enforcement of such rules by the Internal Revenue Service.

SIMPLIFY DEDUCTION RULES FOR QUALIFIED RETIREMENT PLANS

General Explanation

Chapter 17.03

Current Law

In general, amounts paid as deferred compensation are deductible by an employer only as they are included in the income of employees. Moreover, income on amounts set aside by an employer to fund deferred compensation is generally taxable to the employer as earned. Exceptions to these general rules are provided for deferred compensation provided under qualified stock bonus, pension, profit-sharing, and annuity plans. Thus, within certain limits, employer contributions to such qualified plans are currently deductible by the employer even though employees will not be taxable until they receive distributions from the plans. In addition, the income earned on assets held in a qualified plan is not subject to tax while it remains within the plan.

An employer's deduction for contributions to a qualified plan is subject to two separate limitations. The first applies on an individual-by-individual basis and covers contributions to defined contribution plans (i.e., profit-sharing, stock bonus, and money purchase pension plans), defined benefit plans, and combinations of the two. The second limitation applies plan by plan and is based on the total contributions for the group of employees covered by the particular plan. This group-based limitation applies to pension plans (i.e., money purchase pension plans and defined benefit pension plans), profit-sharing and stock bonus plans, and combinations of the two.

The individual-by-individual limitation is as follows: (i) the contributions and other additions on behalf of an individual under a defined contribution plan for a year may not exceed the lesser of $30,000 (indexed beginning in 1988) or 25 percent of the individual's compensation for the year; (ii) the contribution to a defined benefit plan to fund an individual's annual retirement benefit may not exceed the contribution necessary, under reasonable actuarial methods, to fund an annual retirement benefit of $90,000 (indexed beginning in 1988); and (iii) the total contributions with respect to an individual covered by both a defined contribution plan and a defined benefit plan may not exceed a percentage, between 62.5 and 70 (depending on the individual's compensation), of the sum of the two preceding limits. In addition to being nondeductible, contributions in excess of these limits may also trigger disqualification of the plan.

The group-based limitation applies different limits to pension plans and to profit-sharing and stock bonus plans. An employer's deduction for contributions to a pension plan is subject to limitations based on the minimum funding standards applicable to pension plans and on certain other actuarial determinations. An employer's deduction for contributions to a profit-sharing or stock bonus plan is limited to 15 percent of the aggregate compensation paid during the taxable year to all employees in the plan. A carryforward of the unused portion of the 15 percent limit to a succeeding year is permitted, subject to an overall 25 percent of aggregate compensation limit for the succeeding year. Excess contributions may be carried forward and deducted in a succeeding year, subject to the 15 percent of compensation limit for such year.

If an employer contributes to both a pension plan and a profit-sharing or stock bonus plan, the total deduction for a year is limited to the greater of (i) 25 percent of the aggregate compensation paid during the year to the employees covered by the plans, or (ii) the amount necessary to contribute to the pension plan to satisfy the minimum funding standards for such year. An employer may carry forward excess contributions to a succeeding year, but the deduction of current and carryforward contributions for any year is limited to 25 percent of compensation paid for such year.

The group-based deduction limitation also provides special rules with respect to the deductibility of contributions to employee stock ownership plans (ESOPs), which in general are profit-sharing, stock bonus, and money purchase pension plans that invest primarily in employer securities. Contributions to an ESOP to repay principal and interest on a loan incurred by the ESOP for the purpose of buying employer securities may be deductible even though they are in excess of the generally applicable limits. In addition, an employer may be allowed a tax credit in lieu of a deduction for contributions to an ESOP for up to 0.5 percent of the aggregate compensation paid during the year to employees under the ESOP. (Certain other tax preferences also are available with respect to ESOPs: deduction for dividends paid on ESOP stock, partial exclusion of interest on ESOP loans, nonrecognition of gain on certain sales of stock to an ESOP, and assumption of estate tax liability by an ESOP.)

Reasons for Change

The limitations on an employer's deduction for qualified plan contributions are intended to restrict the tax-favored treatment associated with qualified plans for individual employees to amounts reasonably necessary to provide retirement security. Amounts in excess of these limitations are presumptively in excess of the amounts necessary to provide reasonable retirement benefits and should not be eligible for tax advantages.

The current group-based limitation on deductible plan contributions is intended to be more restrictive for contributions to plans that may be used to finance current consumption or otherwise serve nonretirement purposes. Thus, employer deductions for contributions to profit-sharing and stock bonus plans have been subject to greater restrictions, since, unlike pension plans, profit-sharing and stock bonus plans are not subject to minimum funding requirements, are more liberal in permitting pre-retirement distributions, and permit employees to defer or receive employer contributions currently.

Although profit-sharing and stock bonus plans are appropriately subject to greater limitations than pension plans, the current 15 percent of aggregate compensation limit on the deductibility of contributions to profit-sharing and stock bonus plans is not fully effective in restricting the use of these plans. The effectiveness of the 15 percent limit is undermined by the carry forward rules and, in certain situations, the ability of employers to contribute more than 15 percent of compensation for highly paid individuals and less than 15 percent for lower-paid individuals.

In addition, the 25 percent of aggregate compensation deduction limit applies only to combinations of profit-sharing or stock bonus plans and pension plans, rather than to combinations of defined contribution plans and defined benefit pension plans. As a result, an employer may make contributions to a money purchase pension plan and a defined benefit pension plan without regard to the 25 percent of aggregate compensation limit, even though money purchase pension plans are essentially equivalent to profit-sharing and stock bonus plans in that the retirement benefit provided under each is based entirely on the individual's account balance at the time of retirement.

The special tax treatment of ESOPs is also inconsistent with basic retirement policy. ESOPs are not primarily retirement plans, but rather are aimed at promoting employee ownership of employer stock and at facilitating employers in raising capital. By providing increased deduction limits and a tax credit in lieu of a deduction for certain contributions to ESOPs (and by making certain other preferential treatment available with respect to ESOPs), current law permits tax-favored treatment for plans serving nonretirement purposes.

Proposals

The 15 percent of aggregate compensation limit on deductions for contributions to profit-sharing and stock bonus plans would be eliminated. The current annual limit on the contributions and other additions for any individual in a defined contribution plan would be modified so that the contributions to a profit-sharing or stock bonus plan for any individual could not exceed 15 percent of such individual's compensation for the year. Contributions in excess of this limit would be deductible in a succeeding year subject to the 15 percent of compenstion limit for that year. There would be no carryforward of an unused limit to a succeeding year.

The 25 percent of aggregate compensation limit on deductions for total contributions to combinations of pension plans and of profit-sharing or stock bonus plans would be modified by applying the limit to combinations of defined contribution plans and defined benefit plans. Thus, if an employer maintained a money purchase pension plan and a defined benefit pension plan, the employer's deduction for total contributions to both plans would be limited to the lesser of (i) 25 percent of the aggregate compensation paid to the employees covered by the plans, or (ii) the amount necessary to satisfy minimum funding standards for the defined benefit plan.

An excess contribution to a qualified plan would generally not trigger plan disqualification, but rather would be subject to an annual tax of six percent for as long as the excess contribution both remained in the plan and was nondeductible.

The special rules for ESOPs--the tax credit and the special limits for repayments of principal and interest--would be eliminated. Thus, the deductibility of contributions to an ESOP would be governed by the generally applicable deduction limits. (In addition, the deduction for dividends paid on ESOP stock, the partial exclusion of interest on ESOP loans, the nonrecognition of gain on certain sales of stock to an ESOP, and the assumption of estate tax liability by an ESOP would be eliminated.)

Effective Date

The proposals would be effective January 1, 1986.

Analysis

The annual six percent tax on accumulated excess contributions is intended to offset the advantage of tax-free accumulation to which excess contributions are currently entitled. The tax would parallel the tax currently applicable to excess contributions to a tax-sheltered annuity contract or custodial account, individual retirement account or simplified employee pension.

MODIFY ANNUAL LIMITS ON QUALIFIED RETIREMENT PLAN CONTRIBUTIONS AND BENEFITS

General Explanation

CHAPTER 17.04

Current Law

Current law provides favorable tax treatment to funds set aside in qualified employer plans for deferred compensation or retirement savings. Among the qualification requirements applicable to such plans are restrictions on the annual contributions and benefits that may be provided with respect to any individual under the defined contribution plans and defined benefit plans of an employer. For this purpose, defined contribution plans generally include qualified profit-sharing, stock bonus, money purchase pension and annuity plans, tax-sheltered annuities and custodial accounts, and simplified employee pensions. Defined benefit plans for this purpose are limited to defined benefit pension plans. Separate annual limits apply to each individual in a defined contribution plan and to each individual in a defined benefit plan ("separate plan limits"). An "overall limit" also applies to each individual covered by both a defined contribution plan and a defined benefit plan.

The separate plan limit for a defined contribution plan provides generally that the annual contributions, forfeitures, and other additions for any individual may not exceed the lesser of $30,000 (indexed for inflation beginning in 1988) or 25 percent of the individual's compensation for such year. In determining whether the applicable limit is satisfied with respect to an individual for a year, the lesser of (i) one-half of the employee contributions for the year or (ii) the excess of the employee contributions for the year over 6 percent of the individual's compensation for the year are treated as annual additions.

Special rules permit the employees of certain tax-exempt organizations, such as educational institutions, hospitals, and churches, to benefit from contributions and other additions to tax-sheltered annuity contracts and custodial accounts in excess of the general defined contribution plan limits. Similarly, special limits applicable to employee stock ownership plans (ESOPs) permit contributions to exceed the general limits for defined contribution plans.

The separate plan limit for a defined benefit plan provides that the benefit payable with respect to an individual for a year, when expressed as an annual retirement benefit, may not exceed the lesser of $90,000 (indexed for inflation beginning in 1988) or 100 percent of the average of the individual's highest three years of compensation. The defined benefit limit is not violated if the annual benefit

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payable to an individual who has never participated in a defined contribution plan is not in excess of $10,000. If an individual has less than ten years of service with an employer, the $90,000, the 100 percent of compensation, and the $10,000 annual benefit limits are reduced on a pro rata basis.

The overall limit coordinates the contributions and benefits that may be provided to an individual covered by both a defined contribution plan and a defined benefit plan. Calculation of the overall limit is complex, requiring that the sum of the defined contribution fraction and the defined benefit fraction for any individual subject to the separate plan dollar limits for any year not exceed 1.25. For an individual who is subject to the separate plan percentage-of-compensation limits, rather than the dollar limits, the sum of the fractions may not exceed 1.4. The numerator of an individual's defined contribution fraction is the aggregate additions made on behalf of the individual under the plan during all years of the individual's participation, and the denominator is the sum of each of the separate defined contribution plan limits that applied, or would have applied, for each of the individual's years of service with the employer. The defined benefit fraction is the individual's accrued annual retirement benefit over the applicable separate defined benefit plan limit for the year.

In the case of a "top-heavy" plan, i.e., a plan in which more than 60 percent of the total accrued benefits are for key employees (5 percent owners, 1 percent owners with $150,000 in compensation, the ten employees with the largest ownership interests, and officers), the 1.25 limit on the sum of the defined contribution and defined benefit fractions for key employees subject to the separate plan dollar limits is reduced to 1.0. If accrued benefits for the key employees are not greater than 90 percent of the total accrued benefits under the plan and if the non-key employees are provided with the required additional minimum contributions or benefits (section 416(h)(2)), the overall limit for key employees subject to the dollar limits is increased from 1.0 to 1.25.

Reasons for Change

The separate plan and overall limits on annual contributions and benefits reflect a policy that favorable tax treatment should be available only up to levels needed for reasonable retirement savings. The limits under current law, however, are unnecessarily complex and fail to limit the use of qualified plans in a consistent or equitable manner.

Calculation of the overall limit imposes a significant burden on employers and plans, and indeed may be the primary source of complexity in the retirement plan area. It requires an employer to maintain significant records for many employees and to coordinate the contributions and benefits under all of its tax-favored retirement plans.

The overall limit also creates a disincentive for employers to establish both defined contribution and defined benefit plans, since aggregate contributions and benefits to an individual subject to the separate plan dollar limits may not exceed 62.5 percent of the sum of the separate plan limits. In most situations, the maintenance of both a defined contribution plan and a defined benefit plan would better serve the interests of employees generally; younger, more mobile employees tend to be favored by defined contribution plans, while older employees, particularly those close to retirement, generally are favored by defined benefit plans.

The effectiveness of the current limits is undermined by the inconsistency in their application. The separate and overall limits fail to take into account benefits under such tax-favored plans as individual retirement accounts (IRAs). In addition, certain individuals (e.g., participants in tax-sheltered annuity contracts and custodial accounts, and ESOP participants) are permitted to receive annual contributions and benefits in excess of the generally applicable limits. Moreover, the limits consider only the contributions and benefits provided to an individual by a single employer; individuals who have accrued tax-favored benefits with more than one employer may receive total contributions and benefits far in excess of the existing limits. Finally, the limits do not effectively restrict the tax-favored benefits (as compared to the tax-favored contributions) that may be provided to an individual under a defined contribution plan.

In addition, the current limits fail to count all employee contributions and thus disregard the tax advantages such contributions receive. Although not deductible, employee contributions to a qualified plan accumulate income on a tax-deferred basis. Also, highly-paid individuals generally are in a financial position to take disproportionate advantage of the tax benefits for employee contributions to qualified plans.

Finally, the phase-in of the annual defined benefit limits over an individual's first ten years of service with an employer fails to preclude the key employee of an employer, typically a small employer, from delaying the establishment of a defined benefit plan until such employee is close to retirement. Because such a key employee generally will have in excess of ten years of service with the employer, the employee may be provided with a fully funded benefit under the defined benefit plan up to the full, unreduced annual limit. By delaying the establishment of the plan, however, the employer is able to avoid providing benefits to non-key employees who may have worked for the employer in earlier years.

Proposal

The overall limit on the annual contributions and benefits that may be provided to an individual under the defined contribution and defined benefit plans of an employer would be eliminated. For top-heavy plans, however, the existing overall limits would continue to apply.

An additional tax would be applied to taxable, annual benefits distributed to or with respect to a participant from all tax-favored retirement plans, including IRAs and tax-sheltered annuity contracts and custodial accounts. The additional tax would be ten percent of the amount by which such annual benefits exceed 1.25 times the defined benefit dollar limit in effect for the year. The additional tax would be nondeductible for income tax purposes, and losses, deductions, and credits would not be applicable against the tax.

In determining whether the separate plan limit for an employee in a defined contribution plan is satisfied, all employee contributions would be treated as annual additions on behalf of the employee. In addition, the special limits for employees of certain tax-exempt organizations participating in tax-sheltered annuity contracts and custodial accounts and for employees participating in ESOPs would be eliminated.

Finally, the phase-in of the separate defined benefit plan limit over ten years of service with the employer would be modified by providing for a phase-in of the $90,000 annual defined benefit dollar limit over the first ten years of plan participation. A minimum annual benefit would be permitted, however, for low-paid employees near retirement with significant years of service at the time plan participation commences.

Effective Date

The modifications to the annual limits on contributions and benefits would apply for years beginning on or after January 1, 1986. The ten percent additional tax would apply to tax-favored retirement plan distributions made on or after January 1, 1986.

Analysis

Eliminating the overall limit for non-top-heavy plans would eliminate a significant source of complexity and thus should promote adoption of qualified plans. It should also provide employers with a significant incentive to maintain both defined contribution plans and defined benefit plans.

The ten percent additional tax on annual tax-favored distributions in excess of 1.25 times the applicable defined benefit dollar limit for the year is an appropriate limit on an individual's annual tax-favored retirement benefits. For example, if in 1986 an individual receives tax-favored retirement benefits of $200,000, the excess of the $200,000 over $112,500, or $87,500, would be subject to the ten percent tax. This tax would recapture a portion of the tax benefits provided to the excess distributions. By applying at the individual level, rather than on an employer-by-employer basis, the additional tax also would apply to individuals who accrue excess benefits from multiple employers, without requiring significant employer involvement or administrative burden.

Of course, unless required to take a distribution into income by the minimum distribution rules, an individual may avoid the ten percent additional tax on an excess distribution by rolling over some or all of such distribution to an IRA or qualified plan.

IMPOSE TEN PERCENT TAX ON QUALIFIED RETIREMENT PLAN ASSETS REVERTING TO EMPLOYER

General Explanation

Chapter 17.05

Current Law

As a general rule, amounts paid as deferred compensation are deductible by an employer only as they are included in the income of the employee. Moreover, income from amounts set aside to fund deferred compensation is fully taxable to the employer as it is earned. Current law provides exceptions to these general rules for employer contributions to qualified defined benefit plans. Thus, within certain limits, employer contributions to defined benefit plans are currently deductible, even though employees are not taxable until they receive distributions from the plan. In addition, income generated from plan assets is exempt from tax until distributed by the plan. These tax advantages are intended to encourage the creation of qualified plans and thus to improve retirement security for employees.

Current law requires employers to fund qualified defined benefit plans on a "going concern," rather than a "termination," basis; i.e., employers must fund not merely benefits already accrued, but also some portion of the plan's projected benefits. Current minimum funding standards also provide that experience gains (e.g., better-than-expected claims or earnings experience), may not be taken into account in a single year for purposes of determining required contributions, but rather must be amortized over a fifteen-year period. As a result of these funding standards, and because employers may also receive a deduction for certain plan contributions in excess of minimum funding requirements, the funds in a defined benefit plan at any particular time may exceed the amount necessary to fund benefits accrued as of such time.

Although current law generally prohibits the use of plan assets by the employer, upon termination of a plan the employer may receive plan assets in excess of those necessary to fund fixed and contingent benefits as of the date of termination. Plan assets that revert to the employer upon termination generally are included in the employer's gross income.

Reasons for Change

Current law permits employers to gain unintended tax advantages by overfunding defined benefit plans and receiving assets back on plan termination. Although plan assets reverting to the employer are includible in its income, the employer retains the benefit of an initial deduction and of tax-deferral on the plan's income. Such tax-favored treatment is inappropriate where plan assets are not used to provide employee retirement benefits.

The use of qualified plans for nonretirement purposes is evidenced in a number of recent cases in which employers have undertaken transactions that effectively permit the employer to receive assets from a defined benefit plan while continuing to maintain a defined benefit plan for its employees. These transactions are inconsistent with the minimum funding standards for qualified defined benefit plans and undermine the security of the promised benefits in the continuing plans. Although the Treasury Department, along with the Labor Department and the Pension Benefit Guaranty Corporation, have recently issued current law guidelines regarding these transactions, the possibility for significant abuse remains.

Proposal

An additional tax of ten percent of the plan funds reverting to the employer upon plan termination would be imposed on such employer. This tax would be nondeductible for income tax purposes, and could not be offset by losses or other deductions or credits.

Effective Date

The ten percent additional tax would be applicable to qualified plan assets reverting to an employer pursuant to a plan termination on or after the date this proposal as introduced as legislation.

Analysis

The additional tax on plan assets reverting to an employer would parallel the additional tax on early distributions to individuals from tax-favored retirement plans. The additional tax also would be an effective and administratively simple deterrent to transactions designed merely to draw assets from an ongoing defined benefit plan without encouraging employers to substitute defined contribution plans for their terminating defined benefit plans.

REPEAL CASH OR DEFERRED ARRANGEMENT (CODA) PROVISIONS

General Explanation

Chapter 17.06

Current Law

In general, employees are subject to tax not only on compensation actually received but also on amounts the receipt of which is, at the employee's election, deferred until a later year. An exception to this rule of constructive receipt is provided for so-called cash or deferred arrangements (CODAs), under which an employee may elect to defer the receipt of cash compensation and have the deferred amount contributed as an employer contribution to a qualified profit-sharing or stock bonus plan. If the CODA meets certain qualification requirements, the employee is not currently taxable on the deferred amount. Contributions to CODAs are subject to the limits that apply generally to defined contribution plans. Thus, if allowed under the special nondiscrimination test for CODAs, the maximum amount that may be contributed to a CODA on behalf of any individual is the lesser of $30,000 (indexed beginning in 1988) or 25 percent of the individual's compensation.

A CODA is qualified only if the deferred amounts (1) are wholly nonforfeitable, (2) may not be distributed to the employee before the earlier of age 59-1/2, separation from service, disability, or death, and (3) satisfy the "actual deferral percentage test" (the ADP test). In general, the ADP test is satisfied if the average percentage of compensation deferred for "highly compensated employees" does not exceed 150 percent of the average percentage deferred for other employees.

Deductible contributions to an individual retirement account (IRA) are currently limited to the lesser of $2,000 ($2,250 for a spousal IRA) or 100 percent of compensation. Individual contributions to an IRA receive the same tax-deferral advantages as deferred compensation under a CODA. Thus, subject to certain limits, an individual receives a deduction for contributions to an IRA, and is taxable on such amounts only as they are withdrawn from the IRA.

Reasons for Change

The tax-favored treatment applicable to individual and employer-sponsored retirement plans is intended to enhance individual retirement security. Consistent with that policy, the ability to make deductible contributions to tax-favored retirement plans should be made available on a broad and consistent basis.

An employer's contribution of a deferred amount to a retirement plan under a CODA has the same economic and tax effect for the employee as a deductible contribution by the employee to an IRA. Despite this equivalence, the limitations on deferred compensation under a CODA are far more liberal than the IRA contribution limits. Current law thus provides tax benefits for employees of employers maintaining a CODA that substantially exceed those available to other individuals.

Unlike CODAs or other employer-sponsored plans, IRAs are available to all individual taxpayers, without regard to form of employment or occupation. IRAs, thus, are the appropriate vehicle for receipt of deductible retirement plan contributions by individuals.

Proposals

The provisions of the tax law authorizing CODAs would be repealed.

Effective Date

Repeal would be effective for contributions to a CODA on or after January 1, 1986.

Analysis

After repeal of the CODA provisions, the general constructive receipt rules of current law would apply with respect to employee cash or deferred elections. Thus, if an employee has the right to defer the receipt of some or all of his or her cash compensation and to have the deferred amount contributed to a tax-favored retirement plan, the employee would be treated as having received the deferred amounts. This would be the case without regard to whether the employee's election was before or after the period in which the employee earned the compensation subject to the election. Thus, the deferred amount would be included in the employee's gross income and the contributions would be treated as after-tax contributions to the plan. Of course, such after-tax contributions may be deductible subject to the generally applicable IRA deduction limits. See Ch. 17.01, proposing an increase in current IRA deduction limits.

MODIFY RULES FOR BENEFIT FORFEITURES

General Explanation

Chapter 17.07

Current Law

Tax-favored treatment is provided with respect to funds set aside to provide deferred compensation under profit-sharing, pension, and stock bonus plans that satisfy certain qualification requirements. Among these requirements is a rule providing that a pension plan is not qualified unless the plan provides that benefits forfeited upon the separation of an employee's service for the employer maintaining the plan will not be used to increase the benefits any other employee would otherwise receive under the plan. The forfeited amounts must be used to reduce future employer contributions to the plan or to offset plan administrative expenses. The effect of this is to deny benefit increases to employees. Forfeited benefits under a profit-sharing or stock bonus plan may be reallocated to the remaining participants and thus may be used to increase the benefits that the participants would otherwise receive.

Reasons for Change

Uniform rules governing the treatment of forfeitures should be applied to all qualified plans. Also, because forfeitures are treated as contributions and other additions for purposes of the annual limits on contributions, permitting pension plans to reallocate forfeitures among plan participants generally will benefit rank-and-file employees, and not merely highly compensated employees.

Proposal

Qualified pension plans would be permitted to use benefits forfeited by a separated employee to increase the benefits that other employees would otherwise receive under the plan.

Analysis

Under the proposal, a qualified pension plan could provide that forfeited benefits will be used to reduce future employer contributions or to offset administrative expenses, or that forfeitures will be reallocated among the remaining participants.

CHAPTER 18

INTERNATIONAL ISSUES

The Treasury Department proposals would retain the basic scheme for taxing foreign-source income, but would address certain anomalies. A per-country limitation on the foreign tax credit would be instituted to remove the current incentive for corporations with excess foreign tax credits to invest in low-tax foreign jurisdictions. Sourcing rules used in computing the credit and in taxing non-resident aliens and foreign corporations would also be improved. The taxation of income earned by foreign corporations through U.S. branches would be rationalized to bring it more into line with the taxation of income earned through U.S. subsidiaries. Finally, the uncertainty relating to the proper treatment of foreign exchange gain and loss under current law would be resolved with respect to hedged transactions by treating such gain or loss as adjustments to interest.

REFORM FOREIGN TAX CREDIT

General Explanation

Chapter 18.01

Current Law

To avoid international double taxation of income, the United States allows U.S. taxpayers to credit foreign income taxes paid. The amount of credit which may be claimed is limited to the U.S. tax on foreign source income; this limit is measured as the portion of total U.S. tax, before credit, corresponding to the portion that foreign taxable income is of worldwide taxable income. The limitation is calculated on an "overall" basis; that is, the amount of potential credit is the aggregate of income taxes paid to all foreign countries, and foreign source taxable income is the aggregate of taxable income from all foreign countries. In effect, each taxpayer is allowed to average foreign effective tax rates above and below the U.S. rate; only if the average exceeds the U.S. rate are any potential credits denied.

All taxpayers are allowed to credit foreign income taxes that they pay directly. In addition, U.S. multinational corporations are allowed to credit a share of taxes paid by their foreign subsidiary corporations; this feature is called the "deemed paid" or "indirect" foreign tax credit. The share of taxes eligible for credit is related to the share of income repatriated to the U.S. parents. These taxes are subject to the limitation described above.

Reasons for Change

The objective of the foreign tax credit is to avoid double taxation of foreign income. The limitation is intended to prevent abuse by preserving the U.S. tax on domestic income. Assume, for example, that a U.S. taxpayer has $100 of U.S. income and $100 worth of income from country X, and that tax rates are 46 percent in the United States and 60 percent in X. Worldwide taxable income is thus $200 and U.S. tax before credit is $92. An unlimited foreign tax credit would yield only $32 of U.S. tax ($92-$60=$32). Even though a full $100 was earned in the United States, less than $46 in U.S. tax would be paid. In effect, the United States would be refunding the excess $14 of foreign tax paid on foreign income. With a properly designed limitation, the foreign tax credit claimed may not exceed $46, the U.S. tax on the foreign income. The limitation would prevent the credit from reducing U.S. tax on domestic income.

Limiting the credit to the U.S. tax on foreign income country by country, rather than on an overall basis, would be more consistent with this goal and would lead to more rational incentives for investment. Computing the limitation on an overall basis gives many taxpayers a tax-motivated incentive to invest abroad rather than in the United States. To continue the example from the preceding paragraph, note that the U.S. taxpayer investing in X and facing an overall limitation can lower his tax by shifting his investment from the United States to a foreign country with a low tax rate. For example, if he could earn $100 in a country Y, which has no income tax, he would be able to credit the full $60 paid to X, and his net U.S. tax would be only $32. Therefore, the U.S. tax system gives this taxpayer a $14 subsidy to earn $100 in Y rather than at home. The taxpayer is able to reduce his U.S. tax because the overall limitation allows the high tax in X to be averaged with the low tax in Y. Just as excess credits in X should not be allowed to offset U.S. tax on domestic income, the excess credits should not be made available merely because the taxpayer shifts domestic income to Y, a low tax foreign country.

In sum, the overall limitation leads U.S. multinational companies to distort their worldwide investment decisions for purely tax motivated reasons. The overall limitation is also inequitable. Two U.S. taxpayers investing in the same country may face different incentives and pay different net U.S. tax on their investments there, depending on unrelated activities.

Present methods for calculating deemed paid credits also have certain effects which should be corrected. Specifically, measurement of earnings and profits is not done consistently in all instances, the timing of distributions causes opportunities for tax avoidance and unintended tax penalties, and the rules concerning transactions in foreign currencies bias investment incentives in certain cases.

Proposal

The amount of income tax paid to a foreign country which may be claimed as a foreign tax credit in any year would be limited to the U.S. tax on income from that country. The limitation with respect to each country would be a fraction of the total pre-credit U.S. tax, equal to the ratio of taxable income from that country to worldwide taxable income.

The separate "baskets" of income (certain interest, DISC/FSC, and other) defined under current law would be retained and a limitation calculated for each basket within each foreign country. The separate limitation provisions of current law relating to oil and gas extraction income would also be retained and would operate on a country by country basis.

For purposes of these limitations, foreign taxes would be matched as closely as possible with the income to which they relate. Foreign subsidiaries that earn income in countries other than the one in which they are incorporated require special consideration. To prevent taxpayers in such situations from circumventing the per country limitation by mixing highly and lightly taxed foreign income, the proposal will require taxpayers to identify the countries of origin of the income repatriated by the subsidiaries, as well as the countries to which the taxes are paid.

This approach could have harsh results in the case where a foreign subsidiary incorporated in a country that taxes worldwide income has to pay tax (net of foreign tax credit) to this country on income earned elsewhere. The tax would be attributed to the country of incorporation but the income would not. In principle, this situation should be remedied by reassigning the tax to the countries from which the income arises. In practice, such tracing can present difficulties. Therefore, the Treasury Department expects that this issue will be addressed, as necessary, on a bilateral basis through U.S. income tax treaties.

The proposal would allow losses to offset income earned in other countries, with provisions for "recapture" and "regeneration" when income is subsequently earned in the loss country or countries. In the year a loss occurs, it would be prorated against the income earned in all other countries, in proportion to each country's share in taxable income. The loss can have two effects in the year it is prorated. It can reduce U.S. tax liability, by reducing U.S. income and/or lightly taxed foreign income, and it can increase the amount of excess foreign tax credits, by reducing the limitations in high tax countries. When income is subsequently earned in the loss country, each of these effects will be counteracted; the reduction in U.S. liability will be recaptured and the lost credits will be regenerated. The purpose of these rules is to make the total (undiscounted) U.S. tax liability over a period of several years depend only on total income and taxes in each country over the period, and not on the geographic pattern of income and losses in particular years.

Certain changes in the deemed paid credit would be made to ensure consistent measurement of earnings and profits, to prevent manipulation and penalties resulting from the timing of distributions, and to deal with foreign currency translation issues.

Consideration will also be given to indexing certain accumulations and items of foreign source taxable income for inflation. The methods would be as consistent as possible with the methods developed for indexing domestic source concepts. However, alterations may be necessary due to the administrative complexities and other concerns added by the international context in which these rules must operate.

Effective Date

The proposal would be effective, in general, for taxable years beginning on or after January 1, 1986. A five year carryforward of current excess foreign tax credits into the new system would be allowed; taxpayers may choose the country or countries to which they will apply. This rule helps ease the transition to the per country limitation in a natural way. Due to the substantial reduction in U.S. tax rates, however, excess credits generated under the reformed system will not be comparable to pre-reform quantities; therefore, carryback from post to pre-reform years will not be allowed. With these exceptions, the proposal would allow three years of carrybacks and five years of carryforwards on a per country basis.

Pre-reform overall foreign losses that have not been recaptured will require another set of transition rules. Each year, until these pre-reform losses are exhausted, taxpayers will determine the amount that they would have been required to recapture under current rules. This amount of foreign income will then be recharacterized as U.S. source; the taxpayers will be allowed to specify the countries from which this income is to be taken.

Analysis

A per country limitation to the foreign tax credit would eliminate double taxation of foreign income in a way that is in accord with U.S. tax treaties, without distorting the choice between domestic and foreign investment. A U.S. taxpayer deciding between investing in the United States or a foreign country would be less motivated by tax considerations to undertake the less profitable project. In contrast, with the overall limitation, a taxpayer with activities in a high tax foreign country pays less U.S. tax by making an investment in a low tax foreign country than by making an investment in the United States. The averaging of high and low foreign taxes allowed by the overall limitation results in investments being made which would not be profitable but for the tax savings. The proposed reduction in the U.S. corporate tax rate would increase excess foreign tax credits and, accordingly, would increase the incentive to divert investment and income to low-tax countries if the overall limitation were left in place. Adopting a per country limitation, together with the proposed changes in certain source rules, would preserve the U.S. tax on domestic income while avoiding double taxation of foreign income.

Adoption of a per country limitation is consistent with international practice. Most countries which avoid international double taxation by allowing a foreign tax credit use a per country limitation; and a per country limitation was used in the United States for many years (1932-1976), either alone or in combination with the overall limitation.

The proposed changes in the deemed paid credit would also remove biases in investment decisions and treat similar taxpayers more equally.

It is difficult to measure the extent to which investment patterns might be changed by the proposal, but the direction would be toward greater efficiency and equity.

MODIFY SOURCING RULES FOR INCOME AND DEDUCTIONS

General Explanation

Chapter 18.02

Current Law

Rules for defining the source of particular items of income serve two principal purposes. First, those rules define the scope of U.S. taxation of non-resident aliens and foreign corporations, particularly those that do not engage in a U.S. trade or business. Second, through the operation of the foreign tax credit mechanism, the source of income rules define the circumstances under which the United States is willing to concede primary jurisdiction to a foreign country to tax U.S. citizens and residents on income earned by them in that foreign country. In the respects relevant to the proposals set forth below, existing rules for determining the source of income and the allocation and apportionment of related expenses are as follows:

(a) **Income Derived from Purchase and Resale of Property.** Income derived from the purchase and resale of personal property, both tangible and intangible, is sourced at the location where the sale occurs. The place of sale is generally deemed to be the place where title to the property passes to the purchaser.

(b) **Income Derived from Manufacture and Sale of Property.** Income derived from the manufacture of products in one country and their sale in a second country is treated as having a divided source. Generally, such income is allocated one-half on the basis of the place of manufacture and half on the basis of the place of sale (determined under the title passage test), although resort to an independent factory price for purposes of this allocation is permitted if such a price exists.

(c) **Income Derived from License of Intangible Property.** Royalty income derived from the license of intangible property is sourced by reference to the place where the licensed intangible property is used.

(d) **Dividend Income.** Dividend income is generally sourced at the place of incorporation of the payor. However, if a U.S. corporation earns more than 80 percent of its income from foreign sources, dividends paid by that corporation are treated as foreign source income.

(e) **Interest Income.** Interest income is generally sourced on the basis of the residence of the payor. Under one exception to this rule, interest income received from a U.S. corporation which earns more than 80 percent of its income from foreign sources is treated as foreign source income. Other exceptions to the interest source rules are designed to be tax exemptions for limited classes of income.

(f) Interest Expense. Interest expense incurred by a related group of corporations is required to be allocated between domestic and foreign source income in computing foreign source taxable income and the foreign tax credit limitation. Under existing law, this allocation is made on a separate company basis, rather than on a combined group basis. Thus, a company within the related group that incurs interest expense takes only its own operations into account in allocating the expense, rather than the operations of the entire related group.

Reasons for Change

The following basic principles should be applied in formulating rules for determining the source of income. First, appropriate source of income rules should allocate income to the place where the economic activity generating that income occurs. Income derived from the use of property or capital should be sourced where the property or capital is used. Second, the rules should be neutral in the sense that the United States would have no ground for objection if its source of income rules were applied by other countries. Unless there are sufficient reasons to the contrary, international norms for source of income determinations should be followed to the extent such norms exist. Third, the rules should not allow erosion of the legitimate U.S. tax base through taxpayer manipulation of the source rules or of the foreign tax credit limitation. Fourth, the rules should be clear and readily applied. Adoption of a per country foreign tax credit limitation would increase the need for such clarity by requiring sourcing of income to specific foreign countries rather than simply requiring allocation between domestic and all foreign sources.

Existing rules for determining source of income fail to meet these standards in the following respects:

(a) Sales Income. Under the existing title passage test, the source of income derived from the sale of goods bears no necessary relationship to the economic activity generating that income. Because the place of title passage may be arbitrarily determined by affected taxpayers, the existing rule permits artificial manipulation of the foreign tax credit limitation and the U.S. tax base. The possibility of such manipulation is particularly troublesome in connection with transactions between related taxpayers.

(b) Sales of Intangible Property. Income derived from the sale of intangible property is determined under a title passage test while income derived from the license of such property is determined by reference to the place where the property is used. Often the economic distinction between a sale and a license of intangible property is elusive. Clarity and uniformity of treatment would be served by applying the same source of income rules to all transactions involving intangible property.

(c) **Dividend Income.** The existing source rule applicable to dividend income focuses on the domicile of the corporation distributing the dividend income. This rule, or a close variant of it focusing on the corporation's place of management, is followed in the tax systems of most countries. The rule is clear and easily applied and otherwise satisfies the characteristics of appropriate source rules.

The exception to this general rule for so-called 80-20 companies is much more questionable. It alters a sound, well accepted rule under circumstances where most foreign countries do not assert a competing source based claim to tax the income. This can result in total tax exemption of the dividend both in the United States and the relevant foreign country, and can facilitate tax haven opportunities for taxpayers.

(d) **Interest Income.** Just as with dividends, the 80-20 exception to the general source rule applicable to interest income alters an accepted rule in the absence of competing source based claims of foreign countries. Accordingly, the 80-20 company rule gives rise to tax haven type opportunities for some taxpayers and to opportunities for manipulation of the foreign tax credit limitation.

(e) **Interest Expense.** The separate company method of allocation enables taxpayers to limit artificially the interest expense allocated to foreign source income by manipulating the corporate structure of the related group. This may result in an unwarranted increase in the amount of foreign tax credit available to a related group of corporations.

Proposal

(a) **Source Rules Relating to Sales Income.** In general, income derived from the purchase and resale of inventory-type goods would be sourced in the country of the taxpayer's residence. An exception to this general rule would be provided if the predominant portion of the selling activity generating the income is carried on through a fixed place of business located outside the taxpayer's country of residence. In such a case, the income would be sourced in the country where the fixed place of business is located. The place where title to the goods passes to the buyer, the place where purchasing activity is carried out and the place of ultimate destination of the goods all would be irrelevant for purposes of determining the source of sales income. It is believed that this rule would correlate the source of sales income more closely with the location of the underlying selling activity without necessitating in every case an administratively complex determination of where the relevant sales activity occurs.

Similar changes would also be made in the rules for determining the source of income derived from the manufacture and sale of products. The existing practice of sourcing one-half of such income on the basis of the place of manufacture would continue. The remaining one-half of the income would be attributed to sales activity and would be sourced on the basis of the rules described in the preceding paragraph. The title passage test would be abandoned. Accordingly, no portion of the income derived from the manufacture of products in the United States and the sale of such products abroad would be sourced in a foreign country unless the predominant selling activity giving rise to the sales is carried out through a fixed place of business in that foreign country. The option of applying an independent factory price in allocating divided source income would be retained, provided that the predominant portion of the relevant sales activity is conducted through a fixed place of business outside the country of manufacture.

Income derived from sales of personal property used by the taxpayer in its business would be sourced in the place where the property is used. Income derived from the sale of personal property not described above, including in particular passive investment property, would be sourced at the place of the taxpayer's residence.

(b) Income Derived from Sales of Intangible Property. The rules relating to royalty income derived from licenses of intangible property would be retained in their present form. Source rules relating to sales of intangible property would be modified to correspond generally to the rules relating to licenses. Accordingly, intangible property related sales income generally would be sourced on the basis of where the underlying property is to be used. Consideration will be given to whether exceptions should be made to this rule for sales of certain types of intangible property.

(c) 80-20 Corporation Rules Relating to Interest and Dividends. The 80-20 corporation exceptions to the general source rules applicable to dividend and interest income would be repealed. Thus, dividend income would be sourced on the basis of the place of incorporation of the corporation paying the dividend. Interest income received from all U.S. residents and domestic corporations would be sourced on the basis of the residence of the payor without looking to the underlying source of the payor's income. Provisions of the existing source rules relating to interest income that are designed to provide tax exemptions for particular activities would not be repealed but would be restructured as overt exemption provisions in the interest of establishing neutral source rules.

(d) Allocation of Interest Expense. Interest expense would be required to be allocated to income from various sources on a combined group basis, rather than on a separate company basis.

Effective Date

The proposals would generally be effective for taxable years beginning on or after January 1, 1986. The modification of the source rule for interest income received from 80-20 corporations would be effective only with respect to interest paid on debt obligations incurred after the date of introduction of the legislation. Transitional rules would be provided for sales made under certain contracts executed prior to the date of introduction of the proposal as legislation.

Analysis

The proposals would create a set of rules for determining the source of income that is less subject to manipulation and more reflective of real underlying economic activity than the existing rules. The new rules would also be more suitable to the computation of the foreign tax credit limitation on a per country basis. It can be anticipated that under these proposals somewhat greater amounts of the income of U.S. taxpayers derived from sales of products to destinations located outside the United States would be treated in the future as domestic source income. As a result some foreign tax credits on income from U.S. economic activity may not be available. However, the United States should retain the primary taxing right over this income.

REPLACE SECOND DIVIDEND TAX WITH BRANCH PROFITS TAX

General Explanation

Chapter 18.03

Current Law

The effectively connected income of a U.S. branch of a foreign corporation is subject to U.S. income tax, but there is no additional tax, comparable to the withholding tax imposed on dividends paid by a U.S. subsidiary of a foreign corporation, on the branch's remittances to the home office. Instead, the tax code provides for the imposition of a U.S. withholding tax, known as the "second dividend tax", on a proportionate part of the dividends paid by the foreign corporation, if more than 50 percent of the corporation's gross income is effectively connected with a U.S. trade or business.

Reasons for Change

A U.S. corporation owned by nonresidents is subject to income tax on its profits, and, in addition, its foreign shareholders are subject to a tax on the dividends which they receive (30 percent by statute, reduced to as little as five percent by treaty). No comparable tax, beyond the corporate tax, is imposed on the distributed profits of a U.S. branch of a foreign corporation. The "second dividend tax" is intended as the analogue to the dividend withholding tax, but it fails to equalize the tax treatment of branches and subsidiaries in many cases. The "second dividend tax" applies only when a majority of the income of the foreign corporation is derived from its U.S. branches, while the dividend withholding tax applies to all distributions of subsidiary profits. Moreover, the enforcement of this tax is very difficult. It is difficult to know when the tax is due and difficult to enforce its collection by a foreign corporation.

Proposal

The "second dividend tax" would be repealed and replaced by an additional tax on the profits of U.S. branches of foreign corporations which would place the branch of a foreign corporation on a more comparable footing with a U.S. subsidiary of a foreign corporation.

All foreign corporations with a branch in the United States (a trade or business under the tax code or a permanent establishment under tax treaties) would be subject to the branch profits tax, unless it is prohibited by an existing U.S. tax treaty. The branch profits tax would not override existing treaties, but the Treasury Department would seek to amend those treaties which now prohibit the tax to permit its imposition. (Many treaties do not prohibit the imposition of such a tax.)

The tax base would be defined so as to approximate the distributed profits of a U.S. subsidiary. The taxable income of the branch as shown on its U.S. corporate tax return would be reduced by the U.S. corporate tax before foreign tax credits and by further adjustment to reflect reinvestment of profits in the branch. To adjust for such reinvestment, increases in net investment in the branch, for both fixed and working capital, would be deducted from the after corporate tax branch profits.

The rate of the branch tax would be the same as the dividend withholding tax rate, currently 30 percent. Where the foreign corporation is resident in a treaty country, the treaty rate applicable to direct investment dividends would apply.

The second withholding tax on interest raises further questions which need to be addressed. If it is decided to repeal that tax, adjustments to the branch profits tax must be considered.

Effective Date

The proposal would take effect for taxable years beginning on or after January 1, 1986.

Analysis

Under the proposal, U.S. tax would apply more evenly to foreign corporations doing business in the United States than under present law. Thus the tax rules would no longer influence a foreign investor's decision whether to operate in the United States through a branch or a subsidiary. (Under current law a branch operation is generally subject to lower U.S. taxes than a subsidiary, if the subsidiary pays dividends.) The branch profits tax is also more easily administrable and enforceable than the "second dividend tax." It can be handled on the regular income tax form of the branch.

There may be situations under bilateral income tax treaties with other countries where the availability of a dividends-paid deduction to a U.S. subsidiary of a company resident in the treaty country will result in heavier U.S. taxation of income earned through a U.S. branch of such company than through a subsidiary. In that event, consideration might be given to granting comparable corporate tax relief to branches of companies resident in the other country in the context of bilateral treaty negotiations.

The proposed change is not likely to have a significant effect on flows of capital into the United States. The latest available data indicate that most foreign corporations operating in the United States through branches are in the finance, insurance and real estate industries, with most of the income attributable to branch banks.

IMPOSE INTEREST TREATMENT ON FOREIGN EXCHANGE GAINS AND LOSSES

General Explanation

Chapter 18.04

Current Law

The Federal income tax consequences with respect to the treatment of foreign exchange rate fluctuations have been uncertain because there is little guidance with respect to such matters in the tax code and regulations, and precedents such as cases, revenue rulings and technical advice memoranda have taken different positions on the same issues.

Reasons for Change

The uncertainty of current law leads to abuse by taxpayers, and whipsawing of the Internal Revenue Service. Over the long run, actual foreign exchange gains and losses adjust for differences in interest rates across currencies. In the case of hedging transactions, the adjustment is almost perfect even in the short run. Making the tax treatment correspond to business and economic reality reduces opportunities for tax abuse and whipsawing.

Proposal

Foreign exchange gain or loss on a business-related foreign-currency-denominated asset that is hedged would be treated as an increase or decrease in the interest income from the asset. Similarly, foreign exchange gain or loss on a business-related foreign-currency-denominated liability would be treated as a decrease or increase in the interest expense on the liability. Gain or loss on the item, e.g., a forward contract, hedging the business-related foreign-currency-denominated asset or liability would also be treated as an adjustment in interest. As a result, foreign exchange gain would be sourced, and foreign exchange loss allocated and apportioned, in the same manner as interest. Although, as proposed, the change only would apply to hedged positions, further consideration will be given to extending these rules to all foreign currency-denominated assets and liabilities.

Effective Date

The modifications in the treatment of exchange gains and losses on business-related hedging transactions would be effective for transactions entered into after enactment. There would be no provisions for phase-in but there would be the opportunity for a taxpayer to elect grandfathering on hedging transactions that are open as of the date of enactment.

Analysis

Treating exchange gains and losses as adjustments in interest would eliminate the uncertainty of current law and correspond to business and economic reality. Gains and losses are treated as adjustments in interest in other areas of the tax code. Treating gains and losses on hedging transactions as an addition to or subtraction from interest may be easily integrated with the tax straddle provisions in the tax code. Moreover, the proposed changes would eliminate the potential for abuse by taxpayers. Since the potential for tax abuse is largely a function of the currency in which the transaction is denominated rather than the substance of the transaction, transactions would continue to correspond to business and economic reality. Thus, eliminating the potential would not have an appreciable direct effect on economic behavior.